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AUDIT PRACTICES IN THE DEPARTMENT OF DEFENSE

HEARING

BEFORE THE

SUBCOMMITTEE ON DEFENSE ACQUISITION POLICY

OF THE

COMMITTEE ON ARMED SERVICES
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

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(99th Congress, 1st Session)

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AUDIT PRACTICES IN THE DEPARTMENT OF DEFENSE

TUESDAY, MARCH 12, 1985

U.S. SENATE,
SUBCOMMITTEE ON DEFENSE ACQUISITION POLICY
OF THE COMMITTEE ON ARMED SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:10 p.m., in room SR-253, Russell Senate Office Building, Senator Dan Quayle (chairman) presiding.

Present: Senators Quayle, Gramm, Levin, Bingaman, and Glenn.

Staff present: Alan R. Yuspeh, general counsel; Alan L. Chvotkin and Jonathan L. Etherton, professional staff members; and Marie Chaillet and Karen Love, staff assistants.

Also present: Romie L. Brownlee, assistant to Senator Warner; Bernard R. Toon and Bill Hunter, assistants to Senator Quayle; DeForest Hamilton, assistant to Senator Denton; John Rasmussen, assistant to Senator Gramm; Edward McGaffigan, Jr., assistant to Senator Bingaman; Charles C. Smith, assistant to Senator Dixon; and Phillip P. Upschulte, assistant to Senator Glenn.

Also present: Bill Mantalto, staff, Small Business Committee.

OPENING STATEMENT BY SENATOR DAN QUAYLE, CHAIRMAN

Senator QUAYLE. The subcommittee will come to order. This subcommittee this afternoon is going to consider the issue of audit policies and practices in the Department of Defense. Before turning to our witnesses, I would like to make a couple of preliminary observations.

First, there has been a lot of concern over the last several months generally related to certain kinds of expenses for which defense contractors are apparently seeking reimbursement by the Federal Government in connection with the sale of weapons systems.

Many costs for which the contractors have apparently sought reimbursement do not necessarily benefit the Government and are not required by the contract, such things as gifts or contributions, entertainment, personal use of corporate aircraft, and certainly the taxpayers should not be asked to bear these costs.

I am certain that many would argue that firms that are predominantly Government contractors regard perhaps these costs as ordinary and necessary business expenses. I think that the issue that we must examine is whether there is any distinguishing factor? In the normal commercial marketplace, there is usually, almost

always, competition, and thus the pressure on the contractor is to control costs. In Government contracting there is sometimes no competition, so there is a need for Government regulation and cost reimbursement.

And I think the distinguishing factor here is what kind of a contract we have. Obviously, if we have a firm fixed price contract, then in fact you have gone through a price competition and Government regulation and cost reimbusement is not an issue.

But where a cost reimbursement is an issue, there are certainly areas that we have to improve upon and areas that I think where we must sort of tighten the requirements and get a better understanding and appreciation of what we are going to allow, because I think the publicity, the preceptions that are generated by this grey area that is out there, is certainly not helpful to the contractors and it is not helpful to the Department of Defense. And more importantly, it is not helpful to national security.

I think a lot of what happened in the Senate Budget Committee, of which I am a member, this week unfortunately, or last week, the gutting of defense, a lot of those votes I think were probably motivated by the perceptions out there that something has gone wrong, so we have got to make sure that our work is done in a competent way, and we have got to have a better understanding of what we have to do.

And I think that some may argue, rightfully so, that the present system does create the wrong incentives. Perhaps it invites the contractor to submit everything and anything, because the larger the amount of submitted expenses the larger the likely amount to be paid by the Government. That kind of a system in my opinion is obviously wrong and it needs to be changed so that the requested allowable costs that are clearly unallowable will not be so painless for the contractors.

I think that where you have clear violations and you have got not just whether it is fradulent, you have a documented pattern of where there have been the submission of these expenses that are clearly unallowable, that we are going to have to look at alternatives to provide incentives not to do that, not just sort of negotiate this out.

But you know, perhaps you get to a certain level of costs that are not reimbursed, that maybe there will be more severe penalties, not just the cost, but that you might double the damages or there might be other remedies. Because I think what we want to do is to get an understanding and then we want to provide incentives to not have this kind of conduct and not to have this kind of grey area that is certainly out there, because I think it is very damaging on both sides of the fence.

Second, we heard from industry representatives in January in a hearing that there was a poor coordination among various audit entities in DOD and that this resulted in duplicated audit effort and wasted resources. And Audit Policy Directive No. 7600.2, issued by DOD on January 10, 1985, is intended to promote coordination, and I would certainly ask that that be made a part of the hearing.

[See attachment to letter dated April 22, 1985, from inspector general which appears in appendix.]

Senator QUAYLE. We do want to look at the issue of audit coordination this afternoon as well. And third, I think that this is probably the first time, at least to my knowledge, that the Inspector General has appeared before the Senate Armed Services Committee, and so we certainly want to welcome him, and he can probably tell us in his statement what he has been doing and what he thinks are areas that we can perhaps help him with.

Finally, I am going to have to bail out of here from time to time, because I am on the Budget Committee and they are meeting this afternoon. We just finished a vote on general revenue sharing and the Exon amendment prevailed, which is the typical courageous vote saying that we want to cut general revenue sharing funds but we do not want to do it this year. So we froze it in 1986 and then reduced it by about a third in the out years.

So you can pretty well be assured that that program, like all the other programs, except for defense, I might add, has gone really untouched in the proceedings in the Budget Committee thus far. We will have to see what the final outcome is.

But I may have to turn this over to Senator Gramm from time to time to go up there and make a vote.

At this time I would yield to Senator Levin for any comment he may have.

Senator LEVIN. Just a very brief comment, Mr. Chairman, joining you in welcoming our witnesses here today. I am particularly interested in the expenses that are allowed by our auditors and the process that we go through in determining which expenses are allowable.

As I have prepared for this hearing, I have become concerned that too often the system that we use gives incentives to defense contractors to actually spend more rather than less, since the final profit is based on all of the expenses that are allowed.

Whatever allowable expenses that we permit, our auditors permit, whatever we deem to be reasonable and allowable, will end up being multiplied by the profit percentage, particularly when we have a cost-plus incentive contract, where we look at the overhead that we are going to allow. We are going to presumably allow that contractor to, for instance, rent a car as he travels from city to city.

Well, what kind of car is he going to rent? Will it be a chauffeured limousine or is it going to be a small car? They are probably both allowable expenses. They are both going to be reimbursed by us. If in fact he spends more, his profit is going to be greater, assuming that that is an allowable expense, which most of the time it is going to be.

If in fact we at a company picnic or in the company dining room allow the company to serve lobster instead of peanut butter, the profit will be greater, not less, because the 8 percent or 10 percent or whatever profit we allowed will be multiplied by the expense, and that expense will be larger if we allow the lobster, which we do, rather than the peanut butter.

And so we have an incentive to travel first class, to rent big cars, to have the company outings which are more extravagant rather than less extravagant. That is even where we catch them, where we catch these expenses. Now, how many we catch is going to

depend presumably on what percentage of these expenses we audit and how many auditors we have got and do they look at every 10th, every 100th, every 1,000th, every individual expense. But that is a function of how many people we have got.

But what really troubles me, and what I want to get into today and make sure that I am right on this, is that we have a built-in incentive to spend more money rather than less, an incentive to contractors to spend more money, because their profit will be more if their general and administrative overhead is greater.

And if I am right on that, and I think I am, assuming again these are allowable expenses that I mentioned, the chauffeured car, the large car rather than the small one, and the others that I have mentioned, if I am right on that, we have exactly the reverse incentive in our process that we should have in terms of keeping costs down for the taxpayers of this country.

I am not saying the solution to that is an easy one, because I know what we get into is, what is a reasonable cost, and our auditors have to decide what is a reasonable cost. But assuming they jump that hurdle, let me repeat the point which we have, or the conclusion which we have arrived at.

The more those general and administrative overhead costs are on the part of the contractor, the bigger his profit will be on cost plus incentive contracts and maybe even on fixed price contracts, but at least on cost plus incentive. That is what I want to particularly focus on this afternoon with you, gentlemen.

And there are a lot of other issues which the chairman has mentioned in his opening statement which are very worthy of our attention, including the possible duplication of audits. I know that the industry has been somewhat bedeviled by the feeling that we just have too many auditors and we are duplicating audits.

And if that is so, if there is too much paperwork or if there is too much waste there in dealing with the repetitious or duplicative Government audits, I think we ought to try to correct that. I am certainly interested in that testimony as well.

But my own particular focus this afternoon is going to be on this question of what is allowed in the general and administrative overhead, so-called G&A, and whether my conclusion is correct that the greater the amount of expense that a contractor can engage in the greater his profit is going to be.

Senator QUAYLE. Senator Gramm?

Senator GRAMM. No, thank you, Mr. Chairman.

Senator QUAYLE. Senator Bingaman?

Senator BINGAMAN. I do not have an opening statement, Mr. Chairman. Thank you.

Senator QUAYLE. Our first witness today is Mr. Robert Helm, Assistant Secretary, Comptroller, Department of Defense. And he will be followed by Mr. Joseph Sherick, Inspector General, Department of Defense. Mr. Helm is, I believe, accompanied by Mr. Newton. And Mr. Sherick, you can introduce Mr. Vander Schaaf.

Mr. Helm?

STATEMENT OF HON. ROBERT W. HELM, ASSISTANT SECRETARY OF DEFENSE, COMPTROLLER, ACCOMPANIED BY FREDERICK NEWTON, DEPUTY DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

Mr. HELM. Thank you, Mr. Chairman.

Before starting I would like to introduce Mr. Fred Newton, who is beside me today. He is the Deputy Director of the Defense Contract Audit Agency, and I understand there might be some desire to go into some of the detailed aspects of cost accounting principles today and he is the expert to address those issues to.

I appreciate the opportunity to testify before the subcommittee today on DOD contract audit functions. I have a prepared statement and if I could I would like to submit it for the record and then just conduct a brief summary of that statement, if that is OK.

Senator QUAYLE. Your full statement will be submitted for the record.

Mr. HELM. Thank you.

Mr. Chairman, today I am here to testify on DOD contract audit functions, specifically those relating to the Defense Contract Audit Agency. It is a separate DOD agency. It was established in 1965 initially, updated in 1978 by Secretary of Defense directive. It reports to my office. I have first line supervisory responsibility for DCAA audit activities.

DCAA is responsible for conducting all DOD contract audits in the role as an advisor to the DOD acquisition community. In that role, it conducts preaward and postaward audits, generally dealing with questions of incurred costs and contractor pricing techniques for major DOD contracts.

DCAA consists of a headquarters, 6 regional offices around the country, 128 branch offices in the United States and overseas at major locations, and 290 suboffices located directly at contractor plants. So we have DCAA auditors onsite at major contractor locations.

Currently, DCAA has an end strength of about 4,000 people. About 3,500 of these are auditors. Approximately 25 percent of these people are certified public accountants.

In fiscal year 1985, the DCAA operating budget was about $181 million. Last year DCAA issued about 50,000 audit reports questioning approximately $7.5 billion in contractor costs.

The DCAA workload has been increasing substantially over the years, in direct response to the modernization program that the administration has proposed and which Congress has supported over the last 4 years, and we have recognized that increasing audit responsibility in the last few years. In fiscal year 1985 DCAA end strength was increased by about 485 auditors, and in the fiscal year 1986 defense budget we have proposed an increase of an additional 222 auditors for DCAA.

DCAA also operates an extensive training program for its personnel. There is a training institute located in Tennessee. Approximately 2,700 people per year participate in this training program, as it is not only for new auditors but also refresher courses and advanced programs for experienced auditors. In addition, there is a graduate program available for DCAA personnel in Michigan.

As I mentioned, DCAA has the contract audit mission for the Department of Defense. It is the sole entity supporting the defense acquisition process, and in that role it is the principal financial adviser, or the DCAA auditors are the principal financial advisers, to the various contracting officers in the Department of Defense.

Because there is a great deal of contracting occurring in the Department of Defense, DCAA's activities are allocated on a priority basis to maximize the time and efforts of a limited number of DCAA auditors. The three major priorities for the Defense Contract Audit Agency are:

Preaward audits, whereby the auditors review contractor proposals prior to the signing of a contract and advise the contracting officer on the best possible deal for the Government in contractual terms.

Defective pricing audits are another priority activity of DCAA, in terms of reviewing the correctness of contractor proposals.

Finally, overhead auditing is the third major auditing priority of DCAA. And all of these are scheduled in terms of the best allocation of audit resources to maximize savings.

Mr. Chairman, auditing overhead claims of defense contractors, as I mentioned, is a major responsibility. The Deputy Secretary of Defense has initiated a major effort to reduce overhead costs, which typically have represented about one-third of the price we pay for weapons systems. DCAA is involved in helping establish the interim billing rates for overhead costs and it validates the actual overhead cost claims made by contractors at the end of each year.

The audit of overhead is more than analysis of certain expense accounts. In addition to the determination of allowability of charges, the auditor is also concerned with methods used to allocate the cost of Government contracts, the correctness of the various financial bases used in the apportionment, and the consistency in applying policies and procedures to the Government and other operations, and finally, the reasonableness of the indirect costs allocated to Government work.

Evidence that DCAA is doing its job properly is demonstrated by the amount of overhead costs that it has questioned in the past. Each year, DCAA questions hundreds of millions of dollars in contractor overhead submissions.

This is not, however, to say that DCAA will uncover every single unallowable cost incurred by a contractor. The manpower resources that would be required to perform such a detailed audit would simply be unaffordable. But sampling is a very effective process which plays a very important deterrent role.

Despite the magnitude of DCAA's overhead auditing responsibility and the fact that contracts may take years to close out as a result of contractor actions, audit actions, litigation, and contracting officer actions, the DOD does have a very effective mechanism for protecting itself against improper overhead charges in that interim period. Specifically, the contracting officer works with DCAA auditors to establish an interim billing rate which is lower than the contractor's estimate.

This results in DOD generally paying the contractor less than will be owed to him after final audits and contract settlement.

Thus, the Department has a specific procedure for keeping its money, taxpayers' money, in the Government's pocket until final audit and contract settlement is achieved.

On March 5, the Secretary of Defense signed a memorandum to all DOD components restating this procedure and emphasizing that unallowable overhead expenses shall not be paid by the Government even on an interim basis.

While it is certainly disappointing to see examples of the DOD being improperly billed for unallowable overhead costs, it would be a mistake to conclude that the Government automatically pays these bills. We do not. Unallowable charges are questioned by auditors and that information is provided to the contracting officer for purposes of contract settlement.

Meanwhile, a prudent policy of adjusting interim payments assures that contractors are not incorrectly reimbursed for claimed costs. and I might point out, Mr. Chairman, just as an aside, that actions are being taken all the time to increase the accountability of contractors.

And just today you may have heard that the Secretary of Defense directed that a certificate of overhead cost be required with every DOD contract signed from here on in which would require the corporate officials of a DOD contractor to certify under penalty of perjury that there are no unallowed costs in overhead claims made to the Government, and that all costs included in claims benefit the Department of Defense and are directly related to the defense contracts which the claims address.

[The certificate of overhead costs follows:]

CERTIFICATE OF OVERHEAD COSTS

This is to certify that:

1. I have reviewed the claim submitted herewith;

2. All costs included in this claim for (overhead costs for rate approval) (final settlement for identify period covered by rate) are allowable in accordance with the requirements of contracts to which they apply and with the cost principles of the Department of Defense applicable to those contracts;

3. This claim does not include any costs which are unallowable under applicable cost principles of the Department of Defense, such as (without limitation): advertising and public relations costs (FAR § 31.205–1), contributions and donations (FAR § 31.205–8), entertainment costs (FAR § 31.205–14), fines and penalties (FAR § 31.205–15), lobbying costs (FAR § 31.205–22), defense of fraud proceedings (FAR § 31.205–47), and goodwill (FAR § 31.205–49); and

4. All costs included in this claim benefit the Department of Defense, and are demonstrably related to, or necessary for, the performance of the Department of Defense contract(s) covered by the claim.

I declare under penalty of perjury that the foregoing is true and correct.

Firm:
Signature:
Name of Corporate Official:
Title:
Date of Execution:

Mr. HELM. This is a very significant enforcement action, something which requires the corporate officials of major DOD contractors to personally testify that unallowed claims are not made.

If I could address just briefly the overlap point that was mentioned. It is important to distinguish in terms of audits the operational role that the Defense Contract Audit Agency has as the major adviser to contracting officers and the oversight and investi-

gative role that the IG has. In general, we have found this to be a very suitable relationship.

The IG is responsible for coordinating audit activities of the Department and, while DCAA has a professional work force of approximately 3,400, the Inspector General has a few hundred auditors. His duties encompass DOD's programs and operators and this function sometimes is performed using contractor-provided data or at contractors' facilities.

Between them, this group of auditors reviews hundreds of weapons system programs, tens of thousands of contractors, hundreds of thousands of contractor employees carried under benefit plans, millions of contractual actions, and at least $100 billion worth of outstanding contracts incurring costs on a daily basis.

Even when you consider the 27,000 personnel working for contract administration organizations, any insinuation that contractors are being subjected to unnecessary or excessive surveillance has to be taken, I think, with a grain of salt. The press contains an almost daily litany of selected contractor misdeeds in terms of claims made against the Government.

As I noted earlier, DOD protects itself against such practices through its audit activities and its billing rates. The fact that these activities occur bears out the need for audit capabilities that we have today, and I would certainly not agree that we are over-auditing in any meaningful sense of that word.

In conclusion, Mr. Chairman, the DOD has in DCAA a very professional and effective contract audit capability. The work load it confronts is daunting and it must be approached in a systematic way which emphasizes a cost effective use of audit resources in order to provide the best possible stewardship of defense dollars and to get the most defense for the dollar.

DCAA auditors are on the front line of this activity in terms of eliminating waste, fraud, and abuse. In most instances, media accounts of contractor claims against the Department have been the direct result of audits, and DOD congressional oversight committees make regular use of DCAA audits, a reliance that is born out of a positive experience.

DCAA is tremendously cost effective. Audit activities contributed to actual savings or cost avoidance in defense contracting amounting to about $7.5 billion in fiscal year 1984. On the average, each auditor returns about 30 to 40 times his or her cost in terms of defense dollars saved. This is a formula for efficiency and one that the Department, with Congress' continued support, will continue to capitalize on.

That concludes my summary, Mr. Chairman. Thank you very much.

[The prepared statement of Mr. Helm follows:]

PREPARED STATEMENT OF HON. ROBERT W. HELM, ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

Mr. Chairman and Members of the subcommittee, I appreciate the opportunity to testify this afternoon on contract audit functions in the Department of Defense. Given the attention that DOD contract audit activities have received in the media lately, it is especially appropriate that this topic be discussed and that the Subcommittee on Defense Acquisition Policy become acquainted with the performance and effectiveness of the DOD audit function. The Department's audit activities are con-

ducted by the DOD Inspector General, the internal audit units of the military departments, and, for contract audit matters, by the Defense Contract Audit Agency (DCAA). DCAA is a separate agency of the DOD under the direction, authority, and control of the ASD(C). The Director of DCAA reports to me and my office has first-line supervisory authority over DCAA operations.

The Defense Contract Audit Agency was established in 1965 to perform all necessary contract audit for the Department of Defense by providing accounting and financial advisory services regarding the negotiation, administration, and settlement of contracts and subcontracts to all DOD components responsible for procurement and contract administration. DCAA's services include reviews of cost estimating systems and accounting systems, audits to determine contractors' financial capability, contract proposal evaluations, defective pricing audits and Cost Accounting Standards compliance audits. Most of the agency's work falls under two basic categories of audits: incurred costs and pricing proposals. Under incurred cost audits DCAA reviews contractors' cost submissions and determines whether charges are reasonable, properly allocated to the contract, and not prohibited by contract terms, statute, or regulation. Incurred cost audits are performed for cost reimbursable contracts, most incentive-type fixed-price contracts, equitable adjustment claims, and terminated contracts. This category also includes "operations audits," a special type of audit which evaluates the economy and efficiency of contractor operations and activities.

Pricing proposal reviews are evaluations of contractors' estimates of cost submitted in connection with the negotiation of prices for fixed-price or cost-type contracts, adjusted final prices for redeterminable and cost incentive contracts, spare parts orders, etc. For thse reviews DCAA must consider the adequacy of the cost accounting system, the contrator's estimating methods, historical costs of like or similar items, and, through analysis of contractors' budgetary data, the reasonableness of indirect cost (overhead) projections.

The above description does not include all of DCAA's responsibilities, but it is sufficient, I hope, to help you in understanding the contract audit function. In order of time, these activities occur both prior to contract award, when DCAA advises the contracting officer on the consistency of a contract proposal with all applicable regulations and financial standards, and after contract award, when DCAA assesses the appropriateness of contractors' claims and billings. DCAA also provides similar contract audit services on a reimbursable basis to certain other Government agencies such as NASA and DOE.

The DCAA organization consists of Headquarters staff, six regional offices, and 128 resident and branch offices at various loctions in the United States, the Orient, and Europe. The field office structure is further broken down into approximately 290 suboffices to locate the auditors with the contractors under their cognizance. Total current strength for DCAA is 4,417 persons of whom 3,464 are auditors. The DCAA budget for fiscal year 1985 is $181 million. For fiscal year 1986, a budget request of $193 million was submitted. DOD has recognized an increasing contract audit workload requirement and has regularly requested increased end-strength for DCAA. In fiscal year 1984 Congress approved 401 additional spaces. The fiscal year 1985 program of the fiscal year 1986 budget request included an additional 485 spaces. For the fiscal year 1986 program, 222 more spaces are included. These increases bring DCAA strength up to 4,854, a 30 percent increase since fiscal year 1983. The budget numbers include approximately $20 million for reimbursable work which will be funded by non-DOD departments.

DCAA has a commendable training program. Its institute offers classes in 20 different subject areas, and last year almost 2600 auditors participated in such training. DCAA has a program with Central Michigan University through which participants can earn a masters degree in mangement and supervision. It also provides training assistance for its auditors to earn CPA certificates, and 25 percent of its auditors are Certified Public Accountants and many have also earned graduate degrees. Through these training activities, DCAA maintains a highly professional workforce. DCAA's new hires are primarily composed of recent college graduates who require training in the peculiarities of the defense procurement system and experience in the audit profession. As a result it takes several years before an individual reaches journeyman auditor status.

In order to understand DCAA's role, it is important to distinguish external "contract audit" activities from DOD's other internal audit activities, which are under the cognizance of the Inspector General. Contract audit focuses on the award, administration, and settlement of specific DOD contracts at specific contractor locations. This is a mainline DOD operational responsibility, not an investigative or enforcement responsibility. DCAA is DOD's sole auditing entity dealing with contrac-

tors' accounting records and systems on a day-to-day basis. To the extent that the contracting function requires auditing or financial advisory services based on contractors' financial data, such services must be obtained from DCAA. DCAA's role, then, is limited to providing advisory audit services to procurement and contract administration organizations. DCAA auditors do not make the final decision on contract award or administrative matters.

In recent years, DCAA has experienced a dramatic increase in workload as long-deferred weapon system modernization programs were approved by Congress and procurement activity significantly increased. Currently, the Department completes approximately 50,000 contract actions per day and issues 1300 new prime contracts with an annual value of over $146 billion. In 1979, DCAA reviewed proposals having a value of $98 billion: in 1984 it reviewed 28,000 proposals having a value of $273 billion. Hand-in-hand with this modernization program, the Secretary of Defense has placed a major emphasis on improving the defense acquisition process and promoting efficiency. Some of the steps taken in the name of more effective management have also added to DCAA's workload. Principal among these was the lowering of the dollar threshold for field pricing reviews from $500,000 to $100,000 for firm fixed-price, and $250,000 for fixed-price incentive contract proposals. DCAA is also performing more defective pricing reviews and has intensified its reviews of labor and fringe benefit costs.

DCAA's audit operations are continually monitored by my office with the objective of using contract audit resources effectively and efficiently. For example, consideration is being given to requesting Congress to pass legislation to give DCAA authority to subpoena contract records when access is denied. We are also identifying regulatory and statutory changes needed to clarify contractors' records retention requirements and to provide adequate access to contractors' records. Other initiatives will enhance DCAA's role as the primary financial advisor of contracting officers on contract matters.

As previously stated, DCAA's workforce is presently limited to about 3,500 auditors. With this relatively small number, a prioritization of audit activity is necessary to permit orderly operations given the size of the audit workload. The priority structure established is based on the urgency of the need for audit services and the necessity to meet statutory requirements. Three priorities apply to DCAA's audits. On a day-to-day basis, the most urgent requirement for DCAA's service relates to the award and modification of contracts. Such preaward audits have proven to be the most cost-effective use of DCAA resources, with far and away the largest benefit to the DOD in terms of cost-avoidance and efficient contracting. Since there is also a practical requirement that weapons procurement occur in a timely manner, it is important that the DCAA audit product be available to promote the contracting schedle. DCAA is responsible to assure that contractors comply with P.L. 87-653, the truth in Negotiations Act. This statutory requirement is the so-called defective pricing function conducted by DCAA and is Priority No. 2. DCAA's third priority is to audit costs charged to contracts either directly or indirectly through "overhead" accounts.

Auditing overhead claims of defense contractors is a major DCAA responsibility. The Deputy Secretary of Defense has initiated a major effort to reduce DOD overhead costs, which have represented roughly one-third of the price we pay for weapons systems. DCAA is involved in helping establish the interim billing rate for overhead costs and it validates the actual overhead claims made by contractors at the end of each year. The audit of overhead is more than analysis of certain expense accounts. In addition to the determination of allowability of the charges, the auditor must be concerned with the methods used to allocate the costs to Government contracts, the correctness of the bases used in the apportionment, the consistency in applying policies and procedures to the Government and other operations, and the reasonableness of the indirect costs allocated to Government work. Evidence that DCAA is doing the job properly is demonstrated by the amounts of overhead costs it has questioned in the past. Each year, DCAA questions several hundred millions of dollars of contractor overhead submissions. This, however, is not to say that DCAA will uncover every unallowable cost incurred by a contractor. The manpower resources that would be required to perform such a detailed audit would not be affordable.

Despite the magnitude of the DCAA's overhead auditing responsibility, and the fact that contracts may take years to close-out as a result of contractor actions, audit actions, litigation, and contracting officer actions, the DOD does have a very effective mechanism for protecting itself against improper overhead charges. Specifically, the contracting officer works with DCAA auditors to establish an interim billing rate which is lower than the contractor's estimate. This results in DOD general-

ly paying the contractor less than will be owed to him after final audits and contract settlement. Thus, DOD, has a specific procedure for keeping its money, the taxpayers' money, in the Government's pocket until a final audit and contract settlement is achieved. On March 5, the Secretary of Defense signed a memorandum to all DOD components restating this procedure and emphasizing that unallowable overhead expenses shall not be paid by the Government, even on an interim basis.

While it is certainly disappointing to see examples of the DOD being improperly billed for unallowable overhead costs, it would be a mistake to conclude that the Government automatically pays these bills. We do not. Unallowable charges are questioned by auditors and that information is provided to the contracting officer for purposes of contract settlement. Meanwhile a prudent policy of adjusting interim payments assures that contractors are not incorrectly reimbursed for claimed costs.

Regarding coordination of DOD audit activities, we believe we are experiencing very satisfactory results. When the Inspector General or the GAO starts an audit requiring access to contractors' records or facilities, they usually meet with DCAA to find out what work in the area has already been done by DCAA and how they can utilize DCAA's work in accomplishing their audit objective. For example, a GAO representative appeared recently before a Subcommittee of the House Committee on Armed Services on the Navy's 1978 shipbuilding claim settlement with General Dynamics on the SSN 688 class submarines and testified that the GAO relied almost exclusively on work done by DCAA in verifying that the contractor had complied with settlement terms concerning the contractor's absorption of overrun costs. The Inspector General recently initiated an investigation requiring the performance of a large number of defective pricing reviews. DCAA will perform the audits for the IG at all locations where DCAA has an auditor in residence. While DCAA provides a great deal of audit support to IG investigations, it also has benefited from this cooperation.

Although DCAA usually gets access to contractor's records needed for its mission, access problems do occasionally occur. In one recent case, the Inspector General applied its subpoena authority to assist DCAA in gaining access to certain contractor data. The Inspector General has established procedures for followup on implementation of audit recommendations. DCAA auditors believe that these procedures have resulted in greater attention to and acceptance of audit recommendations.

Complaints have been voiced from time-to-time by defense contractors that duplication of DOD audit effort exists. Contractors are, in fact, subjected to surveillance by a variety of DOD organizations. The Inspector General audits DOD's operations and programs, and this function sometimes is performed by using contractor-provided data or in contractors' facilities. Contracting officers engage in fact-finding activities prior to the award of contracts. Various engineering, technical, pricing and contracts personnel need contractor data to perform this function. After a contract is awarded, the administrative contracting officer has various duties to perform in areas such as quality assurance, engineering, manufacturing operations, facilities management, contract financing and payment, and contract settlement. The DOD employs more than 27,000 people in contract administration functions and they all need access to contractor information to perform their duties. Accordingly, contractors are asked for information from a variety of DOD personnel, but, importantly, they are only asked for information to fulfill the contract audit function by DCAA.

Given that some of the contractors' complaints relate to surveillance by organizations other than DCAA, the question of duplication of audit effort, with its concomitant implication of overauditing, has still been raised. DCAA has a professional workforce of approximately 3,450; the Inspector General has a few hundred auditors whose duties encompass contractor activities. Between them, this group of auditors reviews hundreds of weapon system programs, tens of thousands of contractors, many hundreds of thousands of contractor employees, millions of contractual actions, and at least $100 billion worth of outstanding contracts incurring costs on a daily basis. Even when considering the 27,000 personnel working for contract administration organizations, any insinuation that contractors are being subjected to unnecessary or excessive surveillance must be taken with a grain of salt.

The press contains an almost daily litany of selected contractor misdeeds in overcharging for spares, charging all manner of unallowable or inappropriate costs to Government contracts, shipping nonconforming or defective items, providing weapon systems which do not meet performance requirements, committing contract frauds, and not complying with contractual terms or statutes such as the Truth in Negotiations Act, and Cost Accounting Standards. As I noted earlier, DOD protects itself against such practices through its audit activities. The fact that they occur

bears out the need for the audit capabilites we have today. I would certainly not agree that we are overauditng.

In conclusion, Mr. Chairman, the DOD has in DCAA a highly professional and efficient contract audit capability. The workload it confronts is daunting and must be approached in a systematic way which emphasizes a cost-effective use of audit resources to ensure the best possible stewadship of taxpayer dollars and to achieve the most defense capability for the dollar. DCAA is in the front line of the DOD's intensive efforts against waste, fraud, and abuse. In most instances, the media accounts of contractor claims against the DOD have been the direct results of DCAA audits. DOD congressional oversight committees make regular use of DCAA audits, a reliance borne out of positive experience. DCAA is a tremendously cost-effective DOD tool working on behalf of the American people. DCAA audit activities contributed to actual savings or cost avoidance in defense contracting amounting to $7.5 billion in fiscal year 1984. DCAA auditors are among the most dedicated public servants we have. On average, each auditor returns thirty to forty times his or her cost in terms of defense dollars saved. That is a formula for efficiency and one that, with Congress' continued support, the DOD intends to continue to capitalize upon.

This concludes my prepared statement. I will be pleased to answer any questions you may have.

Senator GRAMM [presiding]. Thank you, Mr. Helm.

Our next statement is by Hon. Joseph H. Sherick, Inspector General, Department of Defense.

STATEMENT OF HON. JOSEPH H. SHERICK, INSPECTOR GENERAL, DEPARTMENT OF DEFENSE, ACCOMPANIED BY DEREK VANDER SCHAAF, DEPUTY INSPECTOR GENERAL, DEPARTMENT OF DEFENSE; JOHN MELCHNER, ASSISTANT INSPECTOR GENERAL FOR AUDITING; AND JAMES CURRY, ASSISTANT INSPECTOR GENERAL FOR AUDIT POLICY AND OVERSIGHT

Mr. SHERICK. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before your subcommittee today. I have a prepared statement which, with your permission, I would like to submit for the record. I would like to summarize that statement now.

Senator GRAMM. We would be happy to print it in the record.

Mr. SHERICK. With me today I have my deputy, Mr. Derek Vander Schaaf, I have my Assistant Inspector General for Auditing, Mr. John Melcher, and my Assistant Inspector General for Audit Policy and Oversight, Mr. James Curry.

Mr. Chairman, on April 20, 1981, Secretary Weinberger established an Office of Assistant to the Secretary for Review and Oversight, whose responsibilities closely paralled those of the inspectors general created by Congress in 1978. In September 1982, during consideration of the Fiscal Year 1983 Defense Authorization Bill, amendments were adopted which established a statutory inspector general for the Department of Defense and incorporated the duties of the Assistant to the Secretary of Defense for Review and Oversight into the Office of the Inspector General.

Congress sought to ensure the independence of the Defense Inspector General, the permanence of his position, and address those duties and responsibilities unique to the Department of Defense. The Department of Defense Inspector General was created by the Defense Authorization Act of Fiscal Year 1983 and for which this committee has responsibility.

I was confirmed as the Defense Inspector General in April 1983 and proceeded to establish an organization built around six Assistant Inspectors General, a Principal Deputy, and Deputy for Pro-

gram Planning, Review, and Management. Three of my Assistant Inspectors General have responsibility related to the audit function:

First, I have an Assistant Inspector General for Auditing who is responsible for carrying out those audits required to establish oversight over all DOD Programs and activities. About 60 percent of our audit emphasis is placed on the defense acquisition process. I believe this is necessary to carry out the specific direction of the Congress as laid out in the Inspector General Act and its legislative history.

Second, I have established an Office of Assistant Inspector General for Audit Followup to ensure that audit recommendations are resolved and, when resolved, that the corrective action is actually implemented. Again, this meets the direction of Congress as laid out in Public Law 96-304.

Finally, I established an Office of an Assistant Inspector General for Audit Policy and Oversight. That office sets policy and oversees the activities of the some 9,600 personnel in the Department's internal audit, contract audit, and internal review organizations. This is in compliance with the DOD provision of the Inspector General Act, which recognized the unique nature of the DOD audit establishment and the needs of the Inspector General in addressing and utilizing this resource in carrying out his broad responsibility.

While I believe the audit resources available to the Department have a good deal of ground to cover, I am also aware that uncoordinated visits to locations can be wasteful to the Government and frustrating and confusing to those being audited. For that reason, we have been very sensitive to the need to coordinate the activity of all of the auditors in the Department.

We are also sensitive to the fact that duplication does cost and waste money, and our charge is to detect and prevent waste, fraud and abuse in the Department of Defense. I was therefore much concerned to learn of the testimony before your subcommittee by Mr. Pownall of Martin Marietta and Mr. Anderson of Lockheed on excessive and duplicative audits by DOD audit organizations.

On February 14, 1985, I wrote to those gentlemen requesting their assistance in identifying the specific facts on duplicative and excessive audits. We have been advised that the requested information would be provided this week. We have not seen it.

We were also advised that their concerns include visits by personnel other than auditors. They are more concerned with visits by should-cost teams and contract administrative teams than auditors from the Defense Contract Audit Agency and the inspector general.

My own analysis of the DOD auditor involvement with Martin Marriett, and Lockheed did not disclose any excess or uncoordinated visits by auditors. It revealed less than 2 manyears of other than DCAA audit contact in all of calendar year 1984.

Nevertheless, because of my concern and that of the Secretary of Defense as a result of their appearance before your subcommittee, I announced a review of DOD organizations involved in internal and contract audit, inspection, contract administration, and procurement functions, as well as the General Accounting Office and other congressional oversight groups. That review is now underway.

That concludes my statement, Mr. Chairman. I would be happy to answer any questions on these or any other topics of interest to the subcommittee.

[The prepared statement of Mr. Sherick follows:]

PREPARED STATEMENT BY HON. JOSEPH H. SHERICK, INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

INTRODUCTION

Good afternoon, Mr. Chairman. I appreciate the opportunity to appear before your Subcommittee to address some of the procurement related unit audit and audit oversight activities of the Office of the Inspector General. I am charged by law to coordinate the activities of my auditors, those of the Military Departments, the Defense Contract Audit Agency, and the General Accounting Office to reduce overlap and duplication.

BACKGROUND

I believe a brief review of the events leading to establishment of an IG in the Department of Defense would be helpful in understanding my current organization and how I carry out my responsibilities under the Inspector General Act of 1978, particularly with respect to the initiation and coordination of audits.

The Congress considered, but did not establish, an Inspector General for the Department of Defense in 1978. They asked instead that the Secretary of Defense conduct a study to determine how best to attack fraud and waste in the Department. The study group concluded that a senior official, reporting to the Secretary of Defense, was required to play a leadership role on behalf of the Secretary in coordinating the Department's overall effort to achieve economy and efficiency in Defense programs. On April 20, 1981, Secretary Weinberger established the position of Assistant to the Secretary of Defense (Review and Oversight) (ATSD(R&O)), and appointed me to the position. My responsibilities closely paralleled the recommendations of the study group.

WHAT KIND OF AN INSPECTOR GENERAL FOR DEFENSE?

Congress continued to press for Inspectors General in all Federal Agencies and legislation was introduced in both the House and the Senate to establish Inspectors General in the Departments of Defense, Justice and Treasury. The Congress was not fully convinced that Defense had gone far enough in establishing an acceptable alternative to an Inspector General. The main concerns expressed were the question of independence and the need for the statutory permanence of the position and supporting organizations.

The matter was taken up through floor amendments to the FY 1983 Defense Authorization Bill. The amendments created an Inspector General for the Department of Defense and resolved the issue of independence by placing the Inspector General under the general supervision of the Secretary of Defense, where he is as independent as all other Inspectors General whose offices were established under the IG Act of 1978. In recognition of Defense's unique role in national security, an exception was made for the Defense Inspector General to be under the authority, direction and control of the Secretary in national security areas.

In the few, specific areas delineated by the law, both the Secretary and the Inspector General are required to report the circumstances to Congress any time the Secretary uses his authority to stop an IG audit or investigation. To date, the Secretary has not used this authority.

The Authorization Bill transferred to the Inspector General a number of existing organizations including the Defense Audit Service, the Defense Criminal Investigative Service, the Defense Logistics Agency Inspector General and the audit policy function formerly the responsibility of the Office of the Comptroller. The Congress also considered a number of options regarding the future of the Defense Contract Audit Agency (DCAA), i.e., placing DCAA totally within the Office of the DOD Inspector General; including only a portion responsible for post-award audits; retaining all of DCAA under the Comptroller.

Congress decided not to transfer DCAA to the Inspector General, DOD. Instead, the Secretary of Defense was directed to transfer not less than 100 positions to the Inspector General to be filled by persons trained to perform contract audits. The Congress was clear in its intent that these auditors would not be used to advise con-

tracting officers in the process of negotiating contracts, a function that remains DCAA's. The Congress provided the IG with a contract audit capability to (1) provide the manpower and technical expertise to oversee and review the work of DCAA, and (2) provide the Inspector General flexibility and resources to look at entire procurements including the internal procurement process and contractual performance in all its aspects.

ORGANIZATION OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

The organization I established to carry out my responsibilities under the IG Act is built around six Assistant Inspectors General, a principal Deputy, and a Deputy for Program Planning, Review and Management. I will not take the Subcommittee's time to describe all aspects of my organization, rather, I will address those elements which conduct audits and audit oversight that could impact contractor operations.

AUDIT OPERATIONS

I have an Assistant Inspector General for Auditing who has 436 auditors for all programs and activities of the Department of Defense with special emphasis on the activities of the Office of the Secretary of Defense and the Defense Agencies.

I have increased the amount of audit time devoted to the Defense acquisition process from about 10 percent of available mandays to something closer to 60 percent. It is in this area that my own auditors are likely to visit contractor plants mostly to confer or review records possessed by employees of the Defense Contract Audit Agency or personnel associated with various contract management activities of the Department located at these plants (i.e., Defense Contract Administration Service, Air Force Contract Management Division, Superintendent of Shipbuilding, Navy, Plant Representatives, etc.).

Three audit groups have been established to pursue our responsibilities in the procurement area:

Major Acquisition Group—four audit teams, one each for land, naval, air and space programs consisting of not only audit talent but engineers, technical experts, and cost estimators—in other words, people with both an auditing and/or acquisition background. The teams do major system audits both on individual systems and families of systems. This group took the lead in the audit of major programs such as procurement of SSN 688 submarines, JVX program, and the DIVAD gun.

Contract Audit Group—four teams, staffed with auditors experienced in doing contract audit work and experienced in the procurement process. They are looking at a number of areas like defective pricing, competition in subcontracting, the Should Cost Program, aircraft engine spare parts pricing, and contract cost mischarging audits.

Acquisition Support Programs Group—like the "acquisition support" implied in its title—the auditors here are doing cross-cutting reviews on a broad base of nonmajor weapon system procurement programs, research, development, test and evaluation support activities, contract administration activities, and acquisition management programs. They have reviewed the Defense Systems Acquisition Review Council (DSARC) process, acquisition of engineering and technical data from contractors, procurement quality assurance, procurement of microchips, and procurement of consulting services.

POLICY AND OVERSIGHT

I also have two other Assistant Inspectors General organizations which play a role in following up on audit activities or who provide policy and oversight to coordinate audit operations.

My Assistant Inspector General for Audit Followup ensures that all audit/manager disagreements are resolved promptly and after management and auditors reach agreement, in accordance with Public Law 96-304, those corrective actions agreed to are implemented. In the past, we had a situation where the auditors would make recommendations to which management would agree or disagree and that would be the end of it. Now, we take action to resolve all issues—nothing is left as an agreement to disagree. Once agreement is reached, and it is determined that corrective action is necessary, we follow up to see that it is in fact taken. Part of the follow up effort is directed at contract audits. Follow up specialists visit contractor plants to ensure that proper procedures are followed in resolution and disposition of these audits. Most of our effort here is directed at resolving disputes between Government contract auditors and Government procurement officials located at plants.

I have an Assistant Inspector General for Audit Policy and Oversight who provides policy and oversees the implementation of that policy as it applies to the 9,600 audit and internal review personnel within the Department. He is concerned that our policy meets GAO and other audit standards and our audits are in fact conducted within these guidelines, that our coverage is adequate and our results of high quality.

My policy and oversight group evaluates the work of all DOD activities relating to contract audit, internal audit, internal reviews, military exchange audit, and independent public audit services.

In the area of contract audit we have conducted or initiated reviews of:

Access to contractor records;

Fraud reorting procedures;

Sufficiency of audits of small contractors.

During these oversight reviews it may be necessary to visit contractor plants, once again,mainly to deal with other Government employees.

Basically, what I have described are those elements of my organization which either conduct audits or may have an impact on the audit proces as it relates to contractor operations.

COVERAGE

While I have 436 auditors in my operational audit group, I also have an oversight and/or policy role with respect to all of the 9,600 personnel in DOD internal audit, internal review and contract audit organizations.

These people, located throughout the world, monitor and evaluate the Department's programs and operations. The DOD spends about $600 million each and every day of the year—Saturdays, Sundays and holidays. We have 5,500 installations or activities located in the United States and 21 countries around the world. We provide employment for about 6.3 million personnel directly or indirectly including Service members, Government civilian workers and those in defense industries. We have over 4 million cataloged items in inventory. In fiscal year 1984, we had 15 million contract actions worth $146 billion and dealt with 60,000 prime contractors. In fiscal year 1983, 22 individual contractors each did a billion dollars or more of business as prime contractors with DOD, over 100 did $100 million or more.

COORDINATION OF AUDIT ACTIVITIES

While I believe that the audit resources available to the Department have a good deal of ground to cover, I am also aware that multiple, uncoordinated visits to a particular location can be wasteful to the Government and frustrating and confusing to those being audited. For that reason I have been sensitive to the need to coordinate the activities of auditors reviewing Defense programs, as required by the Inspector General act of 1978.

In fulfilling these responsibilities to avoid duplication of audit activities, my audit policy organization has undertaken various initiatives which include:

Providing policy guidance on the specific responsibilities of DOD audit organizations in coordination of audit activities;

Oversight review of the coordination between internal audit, internal review, and inspection organizations;

Joint planning activities for DOD internal audit organizations;

Procedures for the exchange of audit plans between DOD internal audit organizations, and GAO.

The clear delineation of audit responsibilities in connection with audits relating to the award and administration of contracts has reduced the opportunities for duplicative audit efforts. The Defense Contract Audit Agency is responsible for audits of contractors' financial records. In contrast, the DOD internal audit organizations are responsibile for auditing the activities of DOD procurement officials, including contracting officers.

Current policy guidance has limited the need for various audit organizations to examine the records of contractors by providing for cooperation between DOD's contract and internal auditors. All DOD internal audit organizations are required to rely upon DCAA as their primary source of information on contract costs. Only when DCAA is unable to provide the requested audit assistance in a timely manner do I ask the internal auditors to examine contractors' records.

The application of this policy is illustrated by a recent DOD-wide audit on the pricing of spare parts. This audit involved a joint effort between the DOD internal audit organizations and DCAA. The internal auditors limited their audit coverage to records maintained by DOD procurement activities, while the DCAA auditors assist-

ed the internal auditors by reviewing contractors' cost records for specific spare parts selected by the internal auditors for detailed review.

My audit planning personnel help avoid duplication by working closely with the GAO to eliminate redundant audit projects where possible. This is accomplished through an exchange of audit plans and a close day-to-day working relationship.

In addition, my Assistant Inspector General for Auditing has established a system of desk officers who are responsible for facilitating the coordination between our auditors, those of the Military Departments, GAO and the Defense Contract Audit Agency. We send copies of our audit announcements and security letters to the services and DCAA. The security letters identify audit projects, travelers' names, approximate period of visit, and the point of contact to be visited at each activity.

DUPLICATE AUDIT COVERAGE

I was very concerned to learn of the testimony before your Subcommittee by Mr. Pownall of the Martin Marietta Corporation and Mr. Anderson of the Lockheed Corporation on excessive and duplicative audits by DOD audit organizations. Since I have the responsibility for avoiding duplication of oversight efforts by DOD audit, inspection and investigative organizations, I directed my Assistant Inspector General for Audit Policy and Oversight to survey the activities of DOD audit organizations on their activities involving Martin Marietta and Lockheed Corporation. An analysis of the information provided by the DOD audit organizations did not indicate any evidence of duplicative or excessive audit coverage.

Martin Marietta and Lockheed combined did $8.8 billion of business in fiscal year 1984 with the DOD, as both prime contractors and subcontractors. Because of the large volume of Government business by these two contractors, the Defense Contract Audit Agency has auditors permanently assigned to 17 Lockheed and Martin Marietta locations. These 135 auditors reviewed over $20 billion in contract proposals dealing with new work and incurred costs on existing contracts at these contractors during the 12 month period ending June 30, 1984.

With respect to the internal auditors, during calendar year 1984, three of the DOD internal audit organizations visited 8 locations of the above two contractors in connection with 22 separate audits. This accounted for less than 2 staff yers of internal audit effort and involved limited contractor support because the vast majority of the work was conducted with Government activities located at these plants.

The four internal audit organizations of the Military Departments and my office, are responsible for auditing the activities of DOD procurement officials, including contracting officers and administrators who may be located at the contractors' plants. Their contact with contractor employees is usually of a limited nature. In contrast, the Defense Contract Audit Agency is responsible for auditing the financial records of the contractor in order to provide financial advice to DOD procurement personnel in connection with the award and administration of DOD contracts.

On February 14, 1985, I wrote to Messrs. Pownall and Anderson requesting their assistance in identifying the specifics on duplicative and excessive audits. We were subsequently advised by representatives from these corporations that the requested information would not be available before the week ending March 16, 1985. These corporate representatives indicated that their concerns may be broader than just audits. They included oversight activities by other than audit organizations. This is understandable given the number of personnel involved in activities related to contractor operations. There are more than 27,000 people worldwide involved in contract administration efforts who may visit contractor plants, such as: Price analysts, contract specialists, industrial engineers, quality assurance specialists, safety personnel, and packaging and traffic management specialists.

In addition, a contractor might be visited by Government budget and accounting personnel, program manager's staff, independent testing personnel, employees of other Government agencies who have contracts such as NASA, and oversight organizations like the EPA or OSHA.

Because of the seriousness with which I take the claims expressed by these corporation representatives on excessive audit coverage, I announced on March 1, 1985, a DOD-wide review of this area. I took this action even though our initial efforts with Martin Marietta and Lockheed did not disclose any excess or uncoordinated visits by auditors. The objective of this review will be to determine whether effective coordination exists between the various DOD organizations involved in the oversight of contractors' operations to preclude unnecessary duplicative efforts. This will include DOD organizations involved in internal and contract audit, inspection, contract administration, and procurement functions, as well as the General Accounting Office and congressional oversight groups.

Mr. Chairman, I have addressed those aspects of my organization which I understand are of specific interest to your subcommittee. I will be happy to respond to your questions on this or any other matter of interest.

Senator QUAYLE [presiding]. Thank you very much, Mr. Sherick.

Let me go ahead. I will begin with questions. Mr. Helm, if recent reports are accurate, there seems to be a lot of submission of reimbursement costs that are obviously not allowable, some clearly not allowable, some in the grey area. Is this a pattern?

How much of this goes on, where reimbursement costs are submitted and they are not allowed? And could you break that down for us in the category of the ones that are not allowed and the ones that you think are clearly not allowable? Do you have any ability to do that for us?

Mr. HELM. Mr. Chairman, I do not have any statistics like that with me today. We could certainly supply them for you for the record with a little bit of time.

The whole question of claims and allowability hinges around the question of reasonableness, as Senator Levin pointed out. That is an issue for which the contracting officer has responsibility. He carries the warrant for contracting.

Some contractors have a history different from the history of other contractors, and based upon that history we settle or we establish a billing rate for contracts intended to make sure that we keep our money in our pocket until the final claim is settled, so that we are not in a position of paying these unallowable things by accident on an interim basis.

And in general we are very successful in that area. Certain contractors have different experiences. In the particular case of General Dynamics, which has been a subject of some concern recently, we have found that General Dynamics generally identifies a smaller proportion of its costs as unallowable as opposed to other contractors or compared to the percent that DCAA generally questions. I think General Dynamics generally identifies about 3 to 4 percent of its general and administration expenses as unallowable. DCAA questions about 18 percent of these claims, but it varies.

But I would be happy to try to provide you some specific statistics.

Senator QUAYLE. Let me run back through those numbers again. You're saying that as a rule General Dynamics and other contractors that are considered good contractors, that do not abuse the system, have unallowable cost reimbursements of about 3 and 4 percent?

Mr. HELM. I was just speaking of General Dynamics, Senator.

Senator QUAYLE. But you put them in a category of having less unallowable costs from any others, right?

Mr. HELM. I would put them in a category of identifying less of their general and administration expense as unallowable. They identify about 3 percent. Three or four percent I believe is the statistic that DCAA has provided. DCAA questions about 18 percent.

So that is one example, and in part it is the reason that special steps were taken to review all of General Dynamics' claims against the Government.

Senator QUAYLE. Why were special procedures set up for General Dynamics?

Mr. HELM. We saw a history there of reporting on unallowable costs that caused us some concern and we felt it warranted a special examination by DCAA. For that reason, the Secretary of Defense took the action of suspending general and administrative payments to General Dynamics pending this review by DCAA.

But I would not want to generalize that that characterizes all defense contractors. That is one statistic that I am aware of right now. I can try and provide other ones for you.

Senator QUAYLE. Let me just run through this. An unallowable cost, you identify it as an unallowable cost; is this a cost they submit to you for reimbursement and you say, through your audit process, that this is an unallowable cost for reimbursement? Is that what an unallowable cost is?

Mr. HELM. Under cost accounting standards, contractors are required to explicitly define their allowable, what they claim as allowable, costs under a contract. And they are also supposed to provide us data on what they regard as unallowable costs.

In other words, they give us total access to their records on a defense contract. And it is very useful to auditors to have information about what the contractor regards as unallowable costs, because it can be used as a tool in assessing the reasonableness of what are claimed as allowable costs.

And the statistic that I mentioned, we find, DCAA has found that General Dynamics in this particular instance claims a smaller percent, it shows us a smaller percent of their cost as unallowable then what DCAA audits, by that margin that I mentioned.

Senator QUAYLE. You mentioned they found that at about 3 or 4 percent of unallowable costs; you found about 18 percent?

Mr. HELM. DCAA questions about 18 percent of the costs that they claim.

Senator QUAYLE. This is just on General Dynamics?

Mr. HELM. Just on General Dynamics.

Senator QUAYLE. OK. Now then that is a gap of about 14 percent; 14 percent applied to how many billions of dollars a year? I mean, what kind of a figure are you talking about here, do you have any idea?

Mr. HELM. With General Dynamics, I have seen the figure $6 to $7 billion a year.

Senator QUAYLE. So would you take, to find out how many unallowable costs that you are questioning that they did not, should I apply 14 percent to that and that would get the figure?

Mr. HELM. We are just talking about overhead in this case.

Senator QUAYLE. I want to get a discussion on unallowable costs. That is what I am trying to get my finger on right now, on what is an unallowable cost, how much you allow, how much you have obviously in this case denied.

Do you have that figure? I mean, do we have a figure on what DCAA, what is a rule of thumb of unallowable costs that you deny per contract, or for at least major contracts? Do you have a figure like that?

Maybe Mr. Newton could comment.

Mr. NEWTON. I do not have a percentage that says x number of costs are unallowable. Perhaps I might be able to assist in the direction you are heading by pointing out that most of the contrac-

tors do a pretty fair job of identifying and excluding those costs which are expressly unallowable in the cost principles.

Now, that is not to say all of them do by any means. But my guess would be a little bit better than half, around, would be doing a fair job.

Senator QUAYLE. Half would be doing a fair job and the other half would be doing——

Mr. NEWTON. This is expressly unallowable costs, like entertainment is expressly unallowable, and screening out those costs. The others, we have problems, but they are required under the provision of the cost principles and in particular cost accounting standard 405 requires the contractors to exclude such costs from their billings. So, many of them, we do have to go in and we have to identify those costs.

At General Dynamics, information that has been disclosed shows that they do not do a very good job of excluding it and we have had to spend a lot of work there. But we have been very effective, we believe, in identifying those costs.

Senator QUAYLE. Now then, if you go in and you find a lot of unallowable costs that are going to be denied, what is the penalty? What do you do, just negotiate the bottom line out, and whatever the figure is, do they pay that? Is it a negotiated settlement?

Mr. NEWTON. What we do first is we question the costs, so that the taxpayers' interests are protected insofar as there is not to be a payment to that contractor for those unallowable costs.

But at the same time, our auditors will issue a report on noncompliance with cost accounting standards indicating that that contractor has failed to comply with that contractual requirement to identify, either exclude expressly unallowable costs and identify others which may be directly associated with such costs.

If they are not complying with cost accounting standard [CAS] 405, then that is a recommendation that the contracting officer take that up as, in effect, a system deficiency. Whenever there is a system deficiency involved in a contractor, such as noncompliance with CAS 405, we also will indicate the system deficiencies in our reports on pricing proposals, so that in the course of negotiation of future contracts that we are recommending to the contracting officers in those specific contracting actions to, if you will, penalize the contractor insofar as their lack of cooperation with the Government.

We would hope that the contracting officers would take that as a matter of deliberation when they are determining the amount of profit that they will give to these uncooperative contractors.

Senator QUAYLE. One final question, then I will yield. And I did not want to dwell just on this subject, because there are others I want to cover, and maybe we can get to that later on.

What incentives—what incentives are in the system right now to discourage a contractor from submitting unallowable costs? And perhaps I ought to add to that, what penalties are there if someone has a history of submitting a significant amount of unallowable costs? Are there penalties and what incentives are there for them not to do this in the first place?

Mr. HELM. Well, Mr. Chairman, as I mentioned—and I think you may have been gone—a very significant penalty was just put into

place this morning when the Secretary of Defense approved a certificate of overhead costs to be applied to all defense contracts, signed from here on in, which will require a corporate official to certify under penalty of perjury that all claimed costs are allowable, specifically that there are no unallowable costs in the claim that they are submitting herein.

Senator QUAYLE. So, in that case you are going to get into the criminal aspects, rather than civil aspects of this?

Mr. HELM. Yes.

Senator QUAYLE. And certainly, this shifts the entire dynamics out there, would it not, by the Secretary's statement today on the certificate of overhead?

Mr. HELM. It should certainly get the attention of these corporate officials to bear on this question of claims that they are submitting for overhead costs.

Now, in terms of incentives for not doing it in the first place, if a contractor has a history, as you indicated, of claiming too much, we would adjust the billing rate and they would get less money over the period of the contract pending final resolution.

As we made interim payments on a contract, we would hold more out. Such an adjustment can be made if we see a bad history there. They have, the contractors have, an incentive to get the money as soon as they can get it, and therefore they have an incentive not to engage in activities which would enable them not to receive as much.

Senator QUAYLE. Let me just ask one yes or no question and then I will yield. Do you think that we perhaps need some legislation to specify out some of the incentives and what some of the penalties ought to be in this particular area? Would it be helpful to you?

Right now, I guess I would want to see the specific legislation.

But I mean, is there general legislative guidance that we might be able to give to help clarify and place in the system incentives to not do this in the first place? And if that is done, if legislation that would be rather punitive to those that are going to take advantage of the system that we have right now, where you are clearly unallowable——

Mr. HELM. I am not trying to dance around, Mr. Chairman. I think we would appreciate anything that would be helpful in this regard. But the Secretary of Defense is very committed dealing with this internally in the Department and coming out with all of the incentives that are necessary.

Senator QUAYLE. Senator Levin?

Senator LEVIN. Thank you, Mr. Chairman.

Picking up on the allowable and unallowable claims, because I think that is of very current interest. I also hope to have time to get into the question of duplicative audits, and I would like to hear these gentlemen's response to testimony we will be getting later on this afternoon about duplication. And I do not know but we hope that they will stay in order to respond.

Senator QUAYLE. I want to get into that, too. Maybe we will get into a quick second round.

Senator LEVIN. But getting into the subject of these allowable and unallowable claims just for a moment, we have had on the

books, as I understand it, criminal penalties for false claims. Does that already exist?

Mr. SHERICK. Yes.

Senator LEVIN. We have civil penalties as well. If you have been paid for something which turns out to be unallowable, you have got to reimburse us for it plus interest, is that correct?

Mr. SHERICK. Yes.

Senator LEVIN. So, we have had some things in place at least which should have discouraged the filing or the submission of an unallowable claim. It has not. And some claims, by the way, are reasonably contested as to what is allowable and unallowable.

I mean, obviously, if a company submits 5 percent which they determine is unallowable or 10 percent of the total expenditures of the general and administrative overhead account, and then Government auditors come along and say, no, we think 15 percent should be designated unallowable, there is a difference there which could be, would you not agree, reasonable people differing as to what is allowable or unallowable? Would you agree with that?

Mr. SHERICK. Yes.

Senator LEVIN. In other words, the fact that a claim is submitted which turns out to be unallowable does not mean that it was fraudulent or unreasonable in submitting it, is that right? Some of them, however, are unreasonable and fraudulent.

Mr. SHERICK. That is right, if it is clear on its face that what they claim is what they really spent the money for. But if they come in with a claim for ten gold watches for retirements and they are really spending it for something else, that is fraud.

Senator LEVIN. And if they clearly violate the rules which say that you are not allowed, for instance, to make an allowable claim for a contribution to a political campaign, that is not an allowable claim. If that were submitted as an allowable claim, it is wrong.

But there are many claims which are submitted as allowable where reasonable people can differ. So, we really have an area which sometimes is clear and sometimes is grey.

Mr. HELM. There is a grey area, yes, sir.

Senator LEVIN. And by the way, I am glad the Secretary has this perjury certificate. That is fine, too, because if somebody clearly submits what every reasonable person would say is an unallowable claim they ought to be subject to a criminal and civil penalty.

Now, I want to get to a slightly different question. That is the question of whether or not there is not an incentive in our auditing system to spend money. And let me go through a process with you just for a second. We allow a company to submit—to have what is called a general and administrative overhead percentage, is that right?

We negotiate a percentage with them; Mr. Helm, is that right?

Mr. HELM. Yes.

Senator LEVIN. We say: Look, in negctiating these contracts, take your labor cost, take your material cost, take your direct overhead cost, total them all up, and say it comes to a million dollars. We are now then going to look at your so-called general and administrative overhead, all of the things which cannot be allocated directly. We are going to look at all of those costs: executive salaries, executive expenditures, and a lot of miscellaneous things which you

cannot allocate easily to a particular contract, but which is applied and spent for the whole plant or the whole operation.

And we are going to determine what is a legitimate general and administrative overhead percentage, which we are then going to multiply against your direct labor and overhead costs, direct labor and overhead. Is that right so far?

Mr. HELM. Yes, sir.

Senator LEVIN. Now let us assume a contractor says: My labor, my material, my direct labor and material overhead totals a million dollars, and we are satisfied. We now work out a percentage with them called general and administrative overhead, and let us assume it is 20 percent. They multiply the million dollars times 20 percent and they are entitled to $1.2 million.

So far am I on track?

Mr. HELM. I believe so, sir.

Senator LEVIN. Now we allow him a profit percentage, let us say, of 10 percent. That final 10 percent is multiplied against the $1.2 million in order to determine the profit, is that correct?

Mr. HELM. I believe that is generally correct, Senator. Not to temper the rest of your question, but I would ask you to keep in mind, you do not have procurement officials here this afternoon, but we will try to deal with that.

Senator LEVIN. Well, I think you have with you folks who can help us on this issue. At least I was assured that there would be some.

Mr. NEWTON. Let me clarify one thing. There is no cost plus percentage of cost type of contracting.

Senator LEVIN. I am not talking about cost plus contracts. We have cost plus incentive contracts and we negotiate contracts. In negotiating amounts of contracts, we look at what people's costs are and what people's general and administrative overhead is and what profit which you will legitimately allow, is that right?

Mr. NEWTON. In negotiating a contract, often the consideration or one of the considerations which comes into the profit, I think it is there, is an operation of a percentage like you are talking about. But it is more of a practical expedient in getting there. It is not a contract being let that is x number of cost plus x percentage of whatever those costs are, will be.

Senator LEVIN. But we do have cost plus incentive contracts; is that not right? And even in fixed price contracts, we look at what folks' costs are, is that not right?

Mr. HELM. But as long as we recognize that there is a law that precludes awarding a cost plus percentage of cost contract, then we are on safe ground.

Senator LEVIN. Absolutely. But we do have cost plus incentive contracts; is that right? And we do look at people's costs in determining what the negotiated fixed price will be, right?

Mr. HELM. Yes.

Senator LEVIN. Now let us go back to my point. Is it not correct, under my assumption, a million dollars in costs, direct labor and material costs, direct labor and material overhead, a million dollars, we then say: OK, we worked out a 20-percent general and administrative overhead figure; we will multiply the million by the

20 percent to get you to $1.2 million working out a contract, what is going to be an allowable claim.

And then we multiply the profit against the $1.2 million. Is it not true that there is an incentive built in to increase the general and administrative overhead, because the 10-percent profit is multiplied against that?

Mr. SHERICK. Well, for one thing Senator, it depends upon the nature of the contract. The incentive may be to keep costs down.

Senator LEVIN. But in some contracts, am I correct?

Mr. SHERICK. I am not that great an expert, on all the subtitles of government contracts, but I know that there are incentive fee contracts where the incentive is to keep costs down. There are other contracts which are fixed fee, where the contractor is going to get the fixed fee no matter what his cost is.

Senator LEVIN. Let us get down to the bottom line. Contractors negotiate for as large a percentage on that general and administrative overhead line as they can get, and we negotiate for as low a percentage; is that true?

Mr. SHERICK. It is all subject to final audit.

Senator LEVIN. Absolutely. But is it not true that they negotiate, naturally, for the larger percentage and we negotiate for the smaller percentage? Are you with me so far?

Mr. SHERICK. Yes.

Senator LEVIN. And the larger the percentage, the better off they are; would you agree with me on that? Or else they would not be negotiating for it.

Mr. SHERICK. From their point of view, the better off they are.

Senator LEVIN. Of course. The larger the percentage, the better off they are. And therefore, if you rent a chauffeured limousine which goes into general and administrative overhead, instead of a small car, you are going to have your profit percentage of 10 percent multiplied against that figure, is that not true?

Mr. SHERICK. But their real profit is determined after the final audit.

Senator LEVIN. I understand. In my assumption, it is a 10-percent profit multiplied against your cost; is that not right?

Mr. SHERICK. Yes.

Senator LEVIN. I think this is basic, and I do not think there is disagreement on this. I think it is fundamental to the system which is flawed. And by the way, I am not sure I know the answer to it.

Mr. SHERICK. It is allowable and reasonable costs.

Senator LEVIN. Are you saying that if you have a large car instead of a small car that you are going to disallow that as an unreasonable cost?

Mr. SHERICK. It could be disallowed as being unreasonable.

Senator LEVIN. Do you know one case where a large car instead of a small car rented has been disallowed?

Mr. SHERICK. I do not know of such a case.

Senator LEVIN. No, come on. It is not going to be disallowed.

Do you disallow first-class air fare, by the way?

Mr. SHERICK. Yes.

Senator LEVIN. All right.

Let us just discuss the principle of it, the large car versus a small car.

Mr. NEWTON. We would disallow a limousine in your example earlier in your opening statement. Someone taking a chauffeured limousine versus a regular car, I guarantee you, sir, that we are going to question that.

Senator LEVIN. I want to pick an example where we can agree, just to illustrate a point. Would you agree in my statement—my State makes both large and small cars, so I am helping out my State either way here.

But would you agree that a large car instead of a small car would increase that general and administrative overhead line?

Mr. SHERICK. It should cost more.

Senator LEVIN. And it would increase the general and administrative overhead, and they are both allowable as reasonable; would you agree with that? Forget the chauffeur.

Mr. SHERICK. Not to me; they would not be allowable, however, I defer to the people that audit the contracts every day.

Mr. NEWTON. A contractor can incur more costs in their G&A, whether it be renting a car that is a few dollars more, say, in that range, and which would most likely be such that we could sustain a question on reasonableness aspect of it.

But there are some things, some features within the system that we must keep in mind as well. And one is that in spite of some criticisms around, there is a degree of competition, and a contractor continuing to drive up the cost of an item, and particularly where there is any competition at all in the cost environment, it is going to work against them.

But also, we do have within the system the operation of the audit activity to get those costs out. But at the same time, I would like to point out that the Department of Defense now has a special study of profit, the whole profit activity, with that very point in mind. It is one of their criterion that you are addressing, and that is what can be done to get rid of that feature that can serve as an incentive.

Senator LEVIN. I am glad you are studying the point. To me it seems obvious, and I am glad you are engaged in a study of it.

If the executive salary—and I do not want to pick on executive salaries, big cars, lobsters, or anything else. All I can tell you is it is very straightforward to me: If you increase your overhead that is allowable—and we are talking here about allowable overhead, Mr. Chairman, allowable overhead—the larger that percentage, the better off the company is, because they negotiate for larger percentages.

That is what our negotiations are about. That is very clear by the fact that they are always negotiating for a bigger one and we are negotiating for a smaller one. Nothing could be clearer than the market—if I am sounding market-oriented here, then I will plead guilty. It is very clear to me, the market dictates that the company is going to say, we want a 30-percent overhead figure; we are going to say, hey, no, 10 percent is all we can offer, looking at your pool of expenses, what is allowable, and we would work it out at 20 percent.

But an executive who gets reimbursed for a $100 hotel room instead of a $75 hotel room—and they are both allowable; that one we checked out. They are both allowable and, by the way, maybe should be both allowable. But the executive who stays in the $100 hotel room instead of the $75 hotel room not only stays in a better hotel room, maybe, but more important, increases the profit to his company, because the 10 percent is going to be multiplied against the $100 instead of the $75.

Mr. SHERICK. Yes, if the profit is a percentage of total costs. I do not think anybody could argue with you.

Senator LEVIN. Good. That means we have got an incentive built right into the system to spend more, thereby increasing your profit. The hotel room example is fine. I will settle for that. I could not win the small car, big car fight. I will settle for the hotel room.

Mr. SHERICK. I have not looked at claims for hotel rooms.

Senator LEVIN. That is fine. I will settle for that point because that illustrates the problem to me in that one account. And this is not the problem with the whole system; it is a problem, very fundamental, with the account called general and administrative overhead.

And I will just repeat the clear conclusion which the inspector general just confirmed: The more you spend, providing it is allowable and reasonable—and a $100 hotel room is—the better off you are, not just for that night because you might get a basket of fruit; the better off you are because the 10-percent profit that you are allowed is going to be multiplied against the 100 bucks instead of against the 75 bucks.

And that I think is a mistake. I think we have a system which encourages the contractors we deal with to spend money, and that I think is wrong. Now do not ask me the solution, but I think we have got to find a way of multiplying the profit against a base which does not include those kind of expenses in some way.

I have taken more than my time. Thank you.

Senator QUAYLE. Senator Gramm?

Senator GRAMM. Let me followup on that by just asking you to provide for the record the amount of contracting that is done that guarantees a rate of profit on the basis of expenditures. If Mr. Levin is right, the problem is not just with hotel rooms; the problem is with labor, capital, anything that is expended, which is why we have moved away from cost plus contracting.

So whether this is an empty set of events he is talking about or one that is a lot bigger than he is talking about does not depend on motel rooms; it depends upon how profitability is determined on contracts. And I think it would be nice if this committee knew, and if you would submit for the record or give a guesstimate now and submit for the record, how much of our contracting in percentage terms, dollar terms, ballpark figures, is on a guaranteed profit rate as a percentage of expenditures or as on a cost plus basis. I think that would be useful.

Mr. HELM. Yes, sir. We will submit that for the record, sir. We will be glad to.

[The information follows:]

The Department of Defense does not guarantee profit rates as a percentge of expenditures or on a cost plus basis as the question was posed at the hearing. In a

cost-based contracting environment there is a necessary relationship between profit and estimated costs, expressed in a range of profit rates in departmental policies, such as the "weighted guidelines." The type of contract to be employed determines the method to be used in establishing profit (or fee).

For example, on a cost plus fixed fee contract, the fee (profit) is negotiated when the contract is awarded. If the contractor overruns the contract, the amount of fee remains fixed. Accordingly, the contractor clearly has no incentive to run up his overhead expenses. On an incentive type contract, if the contractor overruns the contract, the fee or profit is reduced according to the prenegotiated incentive share ratio. Conversely, if the contractor underruns the contract, the fee is increased by the incentive share ratio. In this case, the contractor has a positive incentive to hold down overhead costs. Firm-fixed-price contracts most dramatically incentivize the contractor to keep costs under control because the contractor benefits from underruns and absorbs the costs of overruns.

Competition in both the Government sector and commercial sector also encourages a contractor to keep his overhead low. Since overhead expenses are allocated to all contracts, Government and commercial, the contractor who keeps his overhead low will compete better in both markets.

The establishment and negotiation of profit is one of the most important aspects of our contracting policy. It affords contracting officers flexibility in determining the rate of profit they will award. The mechanism for accomplishing this is called the "weighted guidelines" approach. Under this approach, the contracting officer is able to vary profit on each of the cost elements proposed. A contractor who has higher costs typically may get less profit while a more efficient contractor may get a higher profit.

Prior to negotiation, the Defense Contract Audit Agency (DCAA) reviews contractor proposals and performs the necessary cost analysis for each element of cost to be sure that contractor estimates are reasonable. Detailed overhead cost evaluations by the DCAA are the basis for forward pricing rate agreements. For pricing purposes, the contracting officer recognizes only reasonable projected levels of overhead cost incurrence by the contractor. The DCAA auditor assists the contracting officer in the negotiation process to assure that the Government obtains the best price.

The following table shows the number and amounts of contract awards by the Department of Defense during fiscal year 1984:

	Number	Amount (in millions)
Firm fixed price/fixed price with escalation	170,459	$78,509
Fixed price redetermination	908	568
Fixed price incentive	4,961	21,840
Cost-plus fixed fee	21,241	10,440
Cost-plus award fee	3,044	3,946
Cost-plus incentive fee	1,907	6,676
Other cost type	11,362	3,040
Total	213,882	125,019

Senator GRAMM. Let me followup. My problem with this whole idea of overhead is that it flies in the face of everything we see in other things the Federal Government is doing.

But before I go on my tirade, let me follow the Levin approach, which is to establish that I know what I am talking about, which is often a problem here. Now, it is my understanding that in negotiating this general and administrative overhead that what happens is in practicality, is that I as a company sit down and put down all of the stuff that I feel I am entitled to.

Now, you withheld some of my money, and then you go over it and you look at it and you say: Well, we will take this, we will not take that. And then we negotiate, and often we cut a deal where you offer me some amount, some percentage, and I take it or reject it, and we keep negotiating. Is that basically how it works?

Mr. HELM. I think that could characterize certain scenarios, yes.

Senator GRAMM. And how far are you behind all of this business in negotiating with companies? How long does all this take? What is your backlog on this negotiation on overheads?

Mr. SHERICK. My review indicated that with respect to overhead they were from 4 to 7 years behind on final negotiation.

Senator GRAMM. Let me suggest an alternative and you tell me what is wrong with it. If I negotiated with our IRS on expenses, my tax form would be as long as from here to that mirror, and I would claim everything quasi-reasonable and then I would negotiate with IRS. It seems to me that part of the problem here—and it does not have anything to do with you; I do not have any doubt that your people are doing a good job. It is just the system is crazy.

Let me just suggest an alternative and you tell me what is wrong with it. Put the burden on the company.

Mr. SHERICK. I think that is what the Secretary of Defense is doing. He is placing the burden on them to say that what they claim is allowable and reasonable, as opposed to putting the burden on the Government auditor and contracting officer to sort through all of the costs that are claimed and throw out what is unallowable. That is the whole idea.

Senator GRAMM. I think that is a step in the right direction, but I would like to see it go further. I would like to change the whole formal system. I would like to have contractors submit what they claim to be allowable based upon some better guidelines that we might provide legislatively. If they submit a claim that is not allowable, I would like there to be stiff penalties.

Then you do not have to have all of these auditors. You go out and you spot check some fellow, you find that he has got something unallowable, you audit him, you turn up how much he has that is unallowable, and you impose treble damages against him and you come back next year and you audit him again. He is full of unallowables again and you hit him with a fine of 30 percent of his overhead.

It will not take long to stop it. The same reason that I do not submit all these things to IRS, basically because they have got penalties and there is some cost involved in being audited, there are costs involved in not complying with your taxes.

And my point is that clearly one of the problems we have got in trying to be efficient in this whole auditing process is we have got the burden in the wrong place. And I would like to suggest, and I hope that the subcommittee will ultimately deal legislatively with the problem, that we change our auditing system.

It shows great minds run in the same direction that the Secretary came out today with his change, since it is something that I have been talking about with his staff, that we needed to put the burden on the companies, eliminate this negotiating business, define the rules, put the burden on them of making the judgment, and then impose penalties on them if they violate it.

Now, do you all think that is a reasonable approach?

Mr. SHERICK. It sounds good to me. Bob has to speak for himself on this matter.

Mr. HELM. I have no problem with it either, Senator. But I would repeat, I think that the Secretary's certificate goes a long way in

that direction. A senior corporate official runs a real risk if a company submits claims a mile long with clearly unallowable claims.

Senator GRAMM. Define again the risk? I had great joy as you were saying it, but I was not paying as good attention as I should have. What exactly did the Secretary do?

Mr. HELM. A certificate will be required to be signed by a senior corporate official relating to defense contracts. The official must certify that he has reviewed the claims submitted and that all costs included in the claim are allowable in accordance with the requirements of the Department of Defense cost principles, and that the claim does not include any costs which are unallowable under such cost principles, as advertising, contributions, entertainment, fines and penalties, lobbying, defense of fraud proceedings, and goodwill; and further, that all costs included in the claim are demonstrably related to or necessary to the defense contract.

It is a very specific certification.

Senator GRAMM. What happens if that does not turn out to be the case in our judgment?

Mr. HELM. "I declare under penalty of perjury that the foregoing is true and correct." There is a sanction of perjury in the event that that is not the case.

Senator GRAMM. So the idea being they are moving in the direction of what we are talking about?

Mr. HELM. Yes, sir, very definitely.

Senator GRAMM. Thank you, Mr. Chairman.

Senator QUAYLE. Senator Bingaman?

Senator BINGAMAN. Let me just ask a few questions on overhead charges. Tell me if I am right. It seems to me that logically there are three explanations for an overhead charge, a contractor charging something that should not be charged.

One explanation is that the contractor does not know what is allowable and what is not allowable. In other words, he has not read your cost accounting standards or does not understand the way you apply them or some other basis, just does not know what he ought to be charging.

And a second explanation, he knows what he ought to be charging but he makes a mistake and charges something he should not.

A third is that he knows what ought to be charged, but he is intentionally trying to get away with something that should not be charged, and therefore is purposely falsifying what he is doing or, if not falsifying the documents, charging something he knows he should not be.

Are there any other explanations for how a company winds up mischarging things for overhead?

Mr. SHERICK. He may think that the definition is vague and that his costs are allowed under it.

Mr. HELM. There is a grey area that Senator Levin related to of reasonableness, and it is a test that is applied by the contracting officer. The DCAA auditors are very unrelenting people, by and large. It is their job to question claims and they take a rather total interpretation of a cost principle, and they claim a lot. And it is the responsibility of the contracting officer when he settles with the contractor to deal with the question of reasonableness, and that is where this grey area oftentimes gets sorted out.

Senator BINGAMAN. In your opinion, the kinds of charges that General Dynamics is charging that were given such publicity—the employee morale trips and the country club fees and all—which category do those fall into? Is that a questionable, is that a grey area kind of a thing, that General Dynamics just has a disagreement as to how the standard should be applied?

Is that a mistake on their part, or is that an intentional charging of something they know should not be charged?

Mr. HELM. They are clearly unallowable charges, by and large.

Senator BINGAMAN. So you would assume they know that?

Mr. HELM. They either know it or they made a mistake. I cannot distinguish.

Senator BINGAMAN. Now let me ask about the certificate that the Secretary is now going to require everybody to sign. Does that certificate just get at the intentional charging of things that a person knows should not be charged.

Mr. HELM. Yes, sir.

Senator BINGAMAN. It does not get at the mistake problem, and it does not get at the gray area problem by its language? And maybe you could read the language of it to me. I have not been able to see a copy.

Mr. HELM. "This is to certify that:

"I have reviewed the claim submitted herewith;

"All costs included in this claim are allowable in accordance with the requirements of contracts to which they apply and with the cost principles of the Department of Defense applicable to those contracts;

"This claim does not include any costs which are unallowable under applicable cost principles of the Department of Defense." And then it specifies the specific areas that I mentioned.

"All costs included in this claim benefit the Department of Defense and are demonstrably related to or necessary for the performance of the Department of Defense contracts covered by the claim.

"I declare under penalty of perjury that the foregoing is true and correct." And then the firm, signature, name of the corporate official.

So it is clearly a deterrent to including things that are clearly unallowable. The grey area is something that has to be dealt with on a case-by-case basis by the contracting officer.

Senator BINGAMAN. And the mistake problem would not be covered by this as you see it?

Mr. HELM. I am not a lawyer, sir, but as I see it I would suspect not. I would not like to get into the business of interpreting.

Mr. SHERICK. I think mistake would be a defense even if it were included in the claim.

Senator BINGAMAN. So the penalty of perjury—perhaps Mr. Sherick could respond to this. How would this be enforced? Would the Department of Defense—do you have the capabilities within the Department of Defense to prosecute these, or would this be turned over to the Justice Department?

Mr. SHERICK. The DCAA probably would report the alleged perjury. We would investigate it. We would work with the assistant U.S. attorney or the Defense Procurement Fraud Unit, which is a part

of the Department of Justice. It would be handled through the Department of Justice.

Senator BINGAMAN. Mr. Sherick, do you believe that this will be a major factor in deterring the kind of overhead charges that you are aware of presently being charged? Do you believe this will make a major impact on the problem we are discussing today?

Mr. SHERICK. Yes, I do. First it moves the burden to the contractor, and I think that they are in a position to review their claims. Second, I think it puts them on notice that they have to be careful when they make claims, that they do meet the cost accounting standards. There are a lot of decisions by the Contract Appeal Board on what is allowable. They can use these interpretations.

What it does is put the burden on contractors to use those interpretations, as opposed to putting the burden completely on the DCAA auditor.

Senator BINGAMAN. This business of General Dynamics charging 3 to 4 percent of recognziing 3 to 4 percent of their overhead cost as not being allowable and you identifying something around 18 percent as being not allowable, does that not point up a tremendous deficiency in these costs accounting standards?

I mean, if in fact this is an honest difference between people as to what those standards provide for, it seems like a tremendous discrepancy to me to see 3 to 4 percent up to 18 percent.

Mr. HELM. Well, Senator, this grey area certainly exists, and it is an element of that larger percentage factor and it is something that has to be resolved on a case-by-case basis between the contractor and the contracting officer. We are constantly involved in activities to upgrade cost accounting principles and provide better definitions for the auditors to use, and that is constantly being engaged in by the acquisition policy elements of the Department of Defense.

Senator BINGAMAN. Let me ask, Mr. Sherick, you have done a series of audits—and this is somewhat off the subject. If the chairman wants to do this at another time, I would be glad to.

But you have done a series of audits on the DSARC system, as I understand it.

Mr. SHERICK. Yes, sir.

Senator BINGAMAN. I know that they are not audits in the sense that we have been talking about here at all, but I would be interested in getting you to summarize your conclusions from those audits of the DSARC process. I think that would be a very useful thing for the subcommittee to hear, and I do not know if you want to give us a 25-word answer now and then come back later. But I would be anxious to get your views.

Mr. SHERICK. I would like to put my synopsis of those report's in the record.

[Retained in committee files.]

Mr. SHERICK. Basically we found that, in many cases, we need the rules. The rules were precisely established.

The DSARC, as you know, is a decisionmaking body that deals with the acquisition process in the Department of Defense. It sets out certain ground rules, certain requirements for documentation, certain requirements for testing and reporting of testing that are prerequisites to a weapons system moving into the next phase of

development or production. This is the case wherever it happens to be in its life cycle, from concept development through final production.

We found that we knew the rules and in many cases, we avoided our own rules. When we did this we ran into trouble. We looked at a selected number of systems and reported our findings on each one. The reason we were doing that was, it was realtime auditing, to tell the decisionmaker before he made a decision whether the necessary prerequisites had already taken place: Was the testing completed, was the documentation submitted, and so forth?

It was an aid to the process. We found that in many cases that, even though the full requirements had not been complied with, they moved ahead with the decision. That is the result of our study. As I say, we have been doing that now for 2½ years. It is an aid to the acquisition process. I can put the synopsis of our findings in the hearings.

Senator QUAYLE. I think that would be helpful, to put it in there so that we can have that as we deliberate. And if it is something else that we want to examine, we might want to do that. But not only the synopsis, but the whole report.

Mr. SHERICK. Well, we have a whole series of reports.

[The information follows:]

DEPARTMENT OF DEFENSE,
OFFICE OF THE INSPECTOR GENERAL,
Washington, DC, March 27, 1985.

Mr. ALAN R. YUSPEH,
General Counsel, Committee on Armed Services, Russell Senate Office Building, Washington, DC.

DEAR MR. YUSEPH: Enclosed are the 11 Office of Inspector General audit reports [1] on the Defense Systems Acquisition Review Council (DSARC). At the March 12, 1985 hearing on Department of Defense Audit Policy, it was agreed that these reports would be provided to the Subcommittee on Defense Acquisition Policy. Also enclosed are advisory memoranda issued to the Under Secretary of Defense for Research and Engineering during FY83 phase of audits of DSARC.

Please note that three of the audit reports are classified and Report No. 85-048, "Report on the Review of the Light Helicopter Family Program," contains contractor proprietary information and carries the special handling notation For Official Use Only.

RICHARD D. LIEBERMAN,
Deputy Inspector General,
Program Planning, Review and Management.

[NOTE.—The Inspector General audit reports are classified and/or designated For Official Use Only. They are therefore, retained in committee files.]

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Senator QUAYLE. Senator Glenn?

Senator GLENN. Thank you, Mr. Chairman.

Gentleman, we are all aware of all of the publicity that has gone out about some of the costs and so on, and I would like to ask a very simple question. How can it happen that we get $7,000 coffee pots and $700 toilet seats?

Mr. SHERICK. Would you like me to answer?

Senator GLENN. Anybody or all.

Mr. SHERICK. Well, when we go out and buy a C-5A aircraft, we order it fully equipped, and we get it fully equipped. What the contractor does is allocate his overhead costs to the contract.

[1] Enclosures retained in committee files.

Senator GLENN. Are certain parts fur lined or something?

Mr. SHERICK. It is a very straightforward plastic toilet seat. I think if you go on any airliner you would see something quite like it. It is the way they apply their costs, the way they apportion their overhead, and the way they allocate their engineering costs. It is too bad you did not ask the president of Lockheed when he was here. I am sure he would have enjoyed answering.

No one can explain it, Senator, it just happens this way because of the way their accounting systems report their costs.

Mr. HELM. That is right, Senator. The accounting system, in the case of the famous hammer, there were lines and lines of overhead, different kinds of costs related to the total contract of which the hammer was one very small element of, were spread. And some of them were spread into the hammer as well. And it leads to a very misleading impression.

Mr. SHERICK. I think a lot has to do with the way we establish specifications. For instance, the coffee pot, if I remember, was supposed to survive a crash. When that kind of a specification is put in the hands of an engineer and we say in effect, it is crucial; that this is a weapons system and it must survive, the contractor will put all kinds of redundancy, reinforcements and everything else into it.

Then when they apply all of the overheads, the prices come out like that. They are absolutely incredible and ridiculous. For instance, in our spare parts audit, we found a lot of high price spare parts; it was hard to believe, but it was there.

Senator GLENN. Well, must we assume, then, that every part of that airplane is marked up as goofy as that is?

Mr. SHERICK. I hope not. Certainly it could lead you to believe that if their accounting system applied the cost on that part, it possibly could apply it on every other part.

Senator GLENN. Gentlemen, I find this really amazing. I thought I would get an answer here this afternoon that explains how some of these overheads are allocated and so on. And instead, you tell me there is no way to explain it, and you are the inspector general for the Department of Defense. I cannot believe this.

Mr. SHERICK. The Defense Contract Audit Agency. [Laughter.]

Senator GLENN. I have been down this track before, too.

How can you have a bill submitted to you that says coffee pot, $7,000, and you say: Oh, well, that is just overhead, so I approve that thing and let it go.

Mr. NEWTON. As I understand it, the way many of these horror story items have been billed, they have not been billed as stated like, coffee pot, x dollars, for example. But what one would be looking at would be all of the integral parts, as to how much it cost to build something, whether it be a coffee pot or whatever it is, what are the components. And the audit that would be involved would be determining how much it actually does cost that contractor, in accordance with good accounting, how much does it actually cost the contractor to build the object at hand.

Now, the question about whether the object at hand is crazy, as to whether there has been an overdesign or something like that, is not something that any accountant, trained auditor, would be in any position to evaluate. But most certainly, we do look at the

items from the standpoint of, is there a proper accumulation of costs for building a particular object?

And we believe that we do subject those items to a very careful review about the proper allocations of costs. Sometimes the horror stories that you find that get into the media are not at all what they really are presumed to be when one looks back into the accounting records on them. Sometimes they are called allocation problems, but the allocation problems have been found in a number of instances not to be an allocation for accounting purposes, but rather just an administrative allocation to secure billings, to make sure that the costs are being handled in an efficient manner for billing, and not really related to the costs.

Senator GLENN. Do you not try and justify what the costs are that are being presented to you? Do you not try and say: OK, a $7,000 coffee pot or a $600 toilet seat just is not something that is reasonable and we are not going to pay that amount for it? And do you not—or do you just accept their figure on it?

Mr. SHERICK. No, Senator. Those items came to our attention in this way. I conducted a DOD-wide audit of the procurement of spare parts, and we did just that. We looked at the item and we said in effect: What is the contractor's cost for this item, as opposed to what is he billing?

In items where we could not discover the contractor's cost, we looked at the intrinsic value of the item and we went to the engineers and said, what should it cost to manufacture something like this? We looked at, 202 contractors that sold us about $3 billion worth of spare parts in the audit period. We concluded that about 36 percent of the 2,300 parts we reviewed were overpriced. We said we are paying prices that are far in excess of the value and that we should not pay these prices.

We looked at 202 contractors and we found 95 of them were overpricing us on the spare parts that we used in our sample. Now we are going out to everyone of the 95 and DCAA is helping us and we are auditing everything they sold us. We are also saying that we want refunds on these contracts because you have overcharged us.

That is what we are doing. We are out looking specifically for this kind of overpricing in order to get back from the contractor refunds in that whole area. We are going to be performing defective pricing audits where we find it at those 95 contractors.

Senator GLENN. Well, let me give another example here if I might. Here is a part that was a retractor plate, I believe it is, on an F-16. The actual cost of the material—and these are figures rounded off here just for illustrative purposes, but they are approximately correct on the audit, as I understand it.

[The information follows:]

Actual costs

Material	$500
Labor	100

Percentages of

Material overhead	20.7
Labor overhead	652.0
General and administrative total costs	13.3
Profit (total costs and G&A)	14.5

Contract cost for F-16 part

Material	$500
Labor	100
Material overhead (20.7 percent of 500)	103
Labor overhead (652 percent of 100)	652
Subtotal	1,355
General and administrative (13.5 percent of 1,355)	180
Subtotal	1,535
Profit (14.5 percent of 1,535)	223
Total	1,758

Senator GLENN. Actual cost of material, $500; labor, $100. Now, on that, the material overhead was marked up 20.7 percent. Labor overhead was marked up 652 percent. General and administrative was 13 percent of total cost. And profit was 14.5 percent of total cost and general and administrative.

Now, that leaves us then, as you come down to contract cost here, it comes down: material, $500; labor, $100; material overhead, $103; labor overhead, $652 more. That comes out to $1,355. G&A, another $180, which brings it up to $1,535; profit, $223.

So what started out as material $500, labor $100, winds up as a total of $1,758.

Now, is that the usual kind of markup, 652 percent of labor?

Mr. SHERICK. I worked in a manufacturing arsenal, in the cost accounting area at Frankfort Arsenal, and I never saw overhead rates like that.

Mr. NEWTON. While the percentage is high, there are situations in the current high tech environment where the use of robotics and other very expensive computerized types of equipment that are being used, that will cause the overhead as a relationship to direct labor to be very high.

That 652 percent is certainly very high, and I would have to see some specifics on that as to whether that is reasonable or not.

Senator GLENN. Well, I have heard this explained a different way and I do not know whether this is valid or not. I am asking whether it is or is not.

The plant has a certain overall overhead. They make a million dollars or say $10 million on a jet engine. They make a $5 screwdriver over here on the other side someplace. To save all the thing of proportionality here of what the overhead cost is, you do not try and take this proportion and say, OK, we give the big proportion of this jet engine, which would be a small percentage increase of its overall cost, you just say, this plant 5,000 articles and you divide the overhead by that, and so you assign that same amount of overhead to every item, whether it is a $5 screwdriver or a $5 million jet engine.

Is that used or do you make it proportional?

Which way do you do it?

Mr. NEWTON. A beneficial cost analysis is required in determining the allocation base for overhead. That is a fundamental requirement.

Senator GLENN. Is it done proportionally, then?

Mr. NEWTON. It is proportioned in relation to the benefits that the receiving object would bear of the overhead pool. You must

analyze that relationship between the labor and the elements of the pool to see if there is a relationship to direct labor.

For example, right now under initiative that Deputy Secretary Taft has laid out on the Defense Contract Audit Agency, we are assessing the allocation bases in light of the new environment. Where we have in the past been enabled to review and accept direct labor as a base for allocating overhead, now we are looking at it to see, is there some other base that should be used in the circumstances.

If there is the high-technology robotics involved, perhaps we should be looking at some usage factor instead of direct labor to arrive at the beneficial causal relationship which must be used for the allocation base.

Senator GLENN. What percent of DOD contracting is done on a competitive basis?

Mr. SHERICK. I think about 40 percent. At least this is what is claimed.

Senator GLENN. Can we not go much higher than that?

Mr. SHERICK. Certainly the objectives that have been proposed by some in Congress are much higher, 60, 70 percent.

Senator GLENN. I know my time is just about up, Mr. Chairman. But let me just ask one other thing here. On this perjury certificate, as it is called, has that not been against the rules and against the law now, to certify things to the Government as being legitimate bills to the Government that were not correct, that were not allowable?

Mr. SHERICK. Yes, sir. Submitting a claim in effect makes the contractor certify that the costs are all allowable. I do not think he certifies the cost. He presents the cost, but does not make a certification. He just says, here is my claim.

Senator GLENN. When you get a bill from the company, somebody signs it when it comes in certifying that that is the bill from that company, right?

Mr. SHERICK. Yes, there is an invoice.

Senator GLENN. OK. Well, how does a new perjury certificate then do any more than that? It looks to me like we have already had "thou shalt not" on the books, and now you are saying "thou shalt really not" or something. What are we doing?

Mr. SHERICK. We went out and looked at invoices. We found most of them were signed by very low level accounting clerks. They were not signed by anybody who was at any significant level of responsibility. Again, it was not, to the best of my knowledge, this kind of a certification. This is a very clear certification.

Senator GLENN. I know I am over my time, Mr. Chairman. Thank you. We could go on for quite a while here.

Senator QUAYLE. Thank you, Senator Glenn.

I think what we will do, there are a couple more questions I would like to ask. Let us try to limit ourselves to 5 minutes or less than on the second go-round, and then we have got to get on to the industry panel.

Mr. Helm, can your DCAA auditors perform personal income tax services for individuals, individuals employed by the contractors that they are auditing?

Mr. HELM. No, sir, I do not believe so.

Senator QUAYLE. Are they prohibited from doing that?

Mr. SHERICK. I would think it is a conflict of interest.

Senator QUAYLE. Mr. Newton, is that prohibited? I have been told or I was under the impression that this in fact does go on.

Mr. NEWTON. I would consider that a conflict of interest. There are some of our people who do income tax work, but——

Senator QUAYLE. I am talking about doing income tax work for employees of a contractor that DCAA is auditing. Is there a specific prohibition for them to do that?

Mr. NEWTON. I believe there is.

Senator QUAYLE. Could you furnish that for us for the record?

Mr. NEWTON. Yes, sir.

Senator QUAYLE. I think you might find out there is not a specific prohibition. And you might also look into that and see if that in fact is going on, either that or I have gotten erroneous information.

[The information follows:]

DEFENSE CONTRACT AUDIT AGENCY,
Alexandria, VA, March 22, 1985.

Senator DAN QUAYLE,
Chairman, Subcommittee on Defense Acquisition Policy, Armed Services Committee, U.S. Senate, Washington, DC.

DEAR SENATOR QUAYLE: During your Subcommittee's 12 March 1985 hearing on audit policy in the Department of Defense, you asked me whether there are regulations prohibiting DCAA autitors from performing income tax services for employees of defense contractors. I responded affirmative, and you asked that I provide a citation for the record.

As a general matter, a civilian employee of the Government may take a part-time job on his or her own time or pursue an off-duty business ventures. However, these activities are subject to restrictive laws and regulations. A Federal criminal statue (18 U.S.C. 208) prohibits a Government employee from "participating personally and substantially as a Government Officer" in matters in which he or she has a financial interest.

In addition, the Department of Defense Standards of Conduct include restrictions on off-duty employment by civilian employees. These restrictions are general rather than specific and must be applied with common sense on a case-by-case basis. For this reason, specific rules covering every possible situation are not developed. DoD Directive 5500.7, para. XII.A, prohibits outside employment by DoD employees when the outside activity:

a. interferes with, or is not compatible with, the performance of the employee's Government duties;

b. may reasonably be expected to bring discredit on the Government or DCAA; or

c. is otherwise inconsistent with standards of conduct regulations, including the requirement to avoid actions and situations which reasonably can be expected to create the appearance of conflicts of interest.

Our implementation regulation, DCAAR 5500.2, says DCAA expects its employees to: "Refrain from any private business or professional activity which conflicts, or which gives the appearance of conflict with their official duties."

Our employees are required to read DCAAR 5500.2 semiannually and sign a statement affirming understanding and commitment to compliance.

Any additional information on this subject will be provided upon request.

Sincerely,

FRED J. NEWTON,
Deputy Director.

DEFENSE CONTRACT AUDIT AGENCY,
Alexandria, VA, April 5, 1985.

Senator DAN QUAYLE,
Chairman, Subcommittee on Defense Acquisition Policy, Armed Services Committee, U.S. Senate, Washington, DC.

DEAR SENATOR QUAYLE: Following up on testimony at your Subcommittee's 12 March 1985 hearing, Mr. Bill Hunter of your staff advised me that a discussion with

one of our employees disclosed that there may not be a clear cut understanding of the extent our Standards of Conduct prohibit performance of income tax services for contractor employees. Some DCAA employees have been preparing income tax returns for lower level contractor employees as a consequence of part-time employment by income tax service organizations.

We intend for our employees to refrain from any engagement for compensation from employees of contractors regarding whom our employee has any audit responsibility. To make this clear, our General Counsel issued the enclosed April 4, 1985 memorandum to the regional directors with distribution to all field audit offices.

Any additional information on this subject will be provided upon request.

Sincerely,

FRED J. NEWTON, *Deputy Director.*

DEFENSE LEGAL SERVICES,
DEFENSE CONTRACT AUDIT AGENCY,
Alexandria, VA, April 4, 1985.

Memorandum for Regional Directors, DCAA, heads of principal staff elements; manager DCAI; Director, Field Detachment.

Subject: Services to Contractor Employees.

An auditor may not accept any engagement for compensation from employees of contractors for whom he or she has any audit responsibility. All auditors should be aware of this restriction. Confusion about this matter could lead to embarrassment and disciplinary action.

Restrictions on off-duty employment by employees of the Department of Defense are set out in DOD Directive 5500.7 (encl 1 to DCAA 5500.2). Paragraph XII.A of the Directive prohibits outside employment when outside activity:

a. interferes with, or is not compatible with, the performance of the employee's Government duties;

b. may reasonably be expected to bring discredit on the Government or DCAA; or

c. is otherwise inconsistent with Standards of Conduct regulations, including the requirements to avoid actions and situations which reasonably can be expected to create the appearance of conflicts of interests.

In brief, off-duty employment is a prohibited activity if it is related to an employee's official duties, either in an actual sense or by appearance.

When an auditor performs services for an employee of a contractor that is audited by his or her Field Audit Office, there is, at very least, an apparent conflict of interest. It is likely that there is an actual conflict, as well. A DCAA auditor may not continue to represent the Government at a contractor who employs people with whom the auditor has a business relationship. This includes the providing of tax services to such contractor employees.

Any violations of this restriction on outside employment will be viewed as conduct inconsistent with the Standards of Conduct. Please assure that all your personnel are aware of this rule.

JOHN J. QUILL, *General Counsel.*

Expiration date: December 31, 1986.

Senator QUAYLE. Let me ask, Mr. Helm and Mr. Sherick, there has been a complaint, particularly in industry, that there is duplication, that we have got too many checkers in the system and we have got so many checkers out there, "checkers" being auditors, et cetera, that come in and that you have got two or three workers for every checker; and that is you have a checker in there doing auditing or something like that that one of the workers has got to take care of the checker, and that cuts down on the productivity; and therefore, if we would have fewer checkers out there, we would have more productivity and be able to be far more efficient and effective.

Do you think that there is a problem of overlap and duplication of our auditing procedures? And would it make sense that we might want to try to consolidate our auditing functions within DOD to perhaps a single agency, so that there would be some more degree of conformity than what we have right now?

Or is this a complaint that is not warranted?

Mr. HELM. Well, Senator, there is only one contracting audit agency in the Department of Defense, and that is the DCAA. Now, in terms of duplication, if there were different auditors auditing the exact same contract or something like that, I would say that would be a very undesirable and very counterproductive audit procedure.

But I think by and large you will find auditors from the IG organization and auditors from DCAA, while they might be at the same location simultaneously, they are there for very different purposes.

And there is a very distinct line drawn between the two audit operations of these organizations. DCAA has a definite operational mission to support the contracting officer. The IG is an investigative and oversight role, and one of the things that he has oversight on is the audit procedures of DCAA.

So there is a policing action in that respect. It is the responsibility of the inspector general to coordinate audits to the maximum extent possible so that there is no adverse impact on productivity.

I am aware of complaints from time to time from contractors. We try to minimize the burden like that. But I am not of the opinion that there is a significant problem in that regard. At least it has not been brought to my attention.

Senator QUAYLE. Mr. Sherick, do you see any duplication out there? Do you ever run into auditors and find some of your people doing the same thing that has already been done by somebody else?

Mr. SHERICK. No. First of all, my auditors are not out there auditing as advisors to the contracting officers. They are not looking at the contractors' financial records for that purpose. My auditors are generally involved in DOD-wide audits, for instance the spare parts audit. We had to go into a lot of contractors' plants as we went through that spare parts audit.

For instance, we are investigating and auditing hot line complaints where there are allegations made against a contractor. We have auditors working in support of our criminal investigators when there are criminal allegations made against contractors.

We are also looking at weapons systems. One of the things that the Congress did when it established my office was recognize that there was an artificial line between internal audit and contract audit. We felt that since the Inspector General would be responsible for auditing all programs and activities, as he looked at major weapons systems he should have a right to go not just within the Department of Defense, but also into contractor plants to do his audit to follow the weapons system, if you will, from womb to tomb.

My auditors are not out there doing that type financial record audit; that is approving invoices of the contractors and the like. They are carrying out my responsibility to look at weapons systems and the procurement process.

For instance, we do audit the way our contracting officers operate. That is one of our responsibilities. In the instance of both Lockheed and Martin Marietta I had a total of about 113 man-days in the whole fiscal year, which equates to one-third of a man, in those plants. Only 13 percent of the auditors' contacts were with contractor employees. Most of their contacts were with the con-

tracting officers, with the DCAA auditors, or with property administrators of the contracting officers.

Another example was our audit of Government-owned property in the hands of contractors. This audit was across the whole Government. So it involved my auditors' going into contractors' plants. But this was not a duplication.

One of the things we guard against in our policy is duplication. I have about 436 auditors working for me and the last thing in the world I want to do is start duplicating the work of the 4,000 auditors that DCAA has.

Senator QUAYLE. Very briefly, how widespread is procurement fraud, from your vantage point?

Mr. SHERICK. Well, I would say this: I do not think it is rampant, but I think it is significant.

Senator QUAYLE. You do think it is significant?

Mr. SHERICK. Absolutely.

Senator QUAYLE. Procurement fraud?

Mr. SHERICK. Procurement fraud.

In my own organization, I have over 300 investigations underway right now. And when you include the military departments I would say there are about 1,000 cases underway at any one time.

Senator QUAYLE. Is there any one particular area of fraud that is somewhat common?

Mr. SHERICK. Our priorities are placed this way: One, product substitution. This is where people sell us shoddy material, junk. We have had a lot of cases recently where we have convicted people for selling us soft armor plate, bad parachute shroud lines. This is our No. 1 priority, shoddy material.

The second priority is cost mischarging. This occurs when the contractor gets up against the wall. He has got cost-type Government contracts, and he has fixed price commercial contracts or Government contracts. He sees that his costs are overrunning on his commercial contracts and he arbitrarily tells his people: Put all your labor against the Government contracts.

Our third area of priority is defective pricing. The contractor says: "We will sell you material and equipment at the lowest price he charges his best customers." He does not; he kites the prices.

Those are the kinds of things we are concerned about. As I say, I do not think it is rampant, but I think it is significant.

Senator QUAYLE. Senator Levin?

Senator LEVIN. Thank you, Mr. Chairman.

Briefly, on the certificate, I see that it says it is under penalty of perjury. Is this going to be under oath in every case?

Mr. HELM. Yes, sir.

Senator LEVIN. This is going to apply to a grey area? By your own testimony, you have got a significant number of allowable claims that are filed that are in the grey area where reasonable people can differ; is that a correct understanding of your testimony?

Mr. SHERICK. I think it would apply. He would sign the certificate and the question of whether it was perjury or not, would be a question of intent.

Senator LEVIN. Would it have to be willful and purposeful?

Mr. SHERICK. It would.

Senator LEVIN. So if it is a grey area allowable claim, it will not be subject to perjury?

Mr. SHERICK. I think each one of those would have to be resolved on its merits.

Senator LEVIN. But if it turned out to be a reasonable, people-could-differ, type of a claim, then perjury would not apply in your opinion?

Mr. SHERICK. I do not think you could get a conviction.

Senator LEVIN. Should we prosecute in that case?

Mr. SHERICK. I do not think we should even prosecute.

Senator LEVIN. I do not think we are going to get a hell of a lot done by this, because I think most of the cases will be in the grey area.

Mr. SHERICK. I do not know that most of them will.

Senator LEVIN. Let me go into another subject. Senator Glenn made reference to an F-16 part, and I want you to take a look at the dollars on this, because this illustrates the point that I was trying to make before.

We have two types of issues we talked about so far. One is this allowable claims issue, how do you get at unallowable claims being filed, and that is an important issue which we addressed today. And another question, though, is where the claim is clearly allowable are folks not better off by increasing their general and administrative overhead line?

Now, take a look at this F-16 part. You will see that it is material, it is labor, it is direct material overhead, and it is labor overhead, total $1,355. Can you follow that, Mr. Helm?

Mr. HELM. Yes, sir.

Senator LEVIN. Now, the general and administrative overhead percentage there is 13.5 percent. That is a company, let us assume for the moment, whose executives when they travel stay in $75 hotel rooms, eat chopped steak, rent compact cars, and have salaries on the low side in their company.

Now, someone comes along and says: You know, if instead of renting the $75 room we rent the $150 hotel room—an allowable expense—we have lobster instead of chopped steak when we are on the road—an allowable expense—and we have the big car instead of a small car—an allowable expense—and if we have our salaries on the high side instead of the low side—an allowable expense—we can increase that general and administrative overhead from 13.5 percent to 18.5 percent.

Just follow that for the moment, OK. Would you not agree that their profit, when multiplied against what I have just described, will end up being larger in terms of dollars than what you see on this sheet?

Mr. HELM. Yes, sir.

Senator LEVIN. So is there not an incentive, assuming you can stay within the rubric of allowable expense, to spend as much as you can rather than less, so that when you negotiate these contracts you can have a larger administrative, general and administrative overhead percent?

Mr. HELM. If it stays within the rubric of allowable and reasonable. Reasonable is an important caveat to the allowable.

Senator LEVIN. Then the answer would be yes, provided it is allowable and reasonable?

Mr. HELM. Yes, sir.

Senator LEVIN. What we are doing here, you have got to understand—and I think we all are in agreement on this—we are giving an incentive——

Mr. SHERICK. I voted yes the first time around.

Senator LEVIN. I am just trying to get Mr. Helm on record here.

Mr. HELM. I will vote yes now if it will save time, Senator. [Laughter.]

Senator LEVIN. What we are telling companies in this process of negotiating contracts is, the greater your costs, the greater your dollar profit. And this is the only place I know of, defense contracts, where this is true. I know of no other circumstance like this.

Now, again, this is a separate issue from what is allowable. That is a very important issue which we are addressing here today, or trying to. That is an issue of, assuming it is allowable and reasonable, we are giving folks an incentive to be on the upper side of what is reasonable.

Mr. HELM. Profit policy is something that was mentioned before, and it is continually looked at. Competition, competitive advantage at some point I suppose enters into this as well.

Senator LEVIN. Well, maybe it does if we have a competitive contract, and of course that is another point that Senator Glenn was making. The more competition we have, the better off we all are. That is not our problem. We are not at that point yet, and we are not going to be there for a long time.

And as long as we have non-competitive contracts, which are at least true in half the cases, we have this situation where we are doing exactly the opposite of what we should be doing, exactly the opposite. We should be giving incentives to reduce costs.

The way we negotiate these contracts, we give incentives to increase costs in this one general and administrative overhead line. It is exactly the opposite incentive that we ought to be giving. That is my point on that. I am glad everybody is in agreement on it, and I would hope that we can work on some legislation here to change the way we compute profit so that we do not include areas where we do not want to give incentives to spend more.

Thank you, Mr. Chairman.

Senator QUAYLE. Senator Bingaman?

Senator BINGAMAN. Let me just ask, I gather there is a certificate that is required to be signed by people who are bidding for defense contracts today if the contracts are over $100,000. What does that certificate provide?

Mr. VANDER SCHAAF. That is a certificate of cost and pricing data under the Truth in Negotiations Act, Senator, and it says that the information that the company has provided the Government is complete, accurate and timely at the date referred to in the certification.

That is the basis for us to go back later and determine, if that date was not accurate and complete, to request a refund——

Senator BINGAMAN. In how many cases?

Mr. VANDER SCHAAF [continuing]. Or a reduction in the contract, if the contract is still an active contract.

Senator BINGAMAN. In how many cases have we, roughly how many cases have we actually gone in and enforced that certificate or prosecuted somebody or forced some change?

Mr. VANDER SCHAAF. There is no prosecution involved in this. We enforce that certificate regularly on a routine basis. That is the second priority of the Defense Contract Audit Agency, and in some respects, has probably been the number one priority of the contract audit capability of the DOD Inspector General.

We are going back and looking for defective pricing in all of the contractors who in our early sample on spare parts, had overpriced us. We are having a fairly high rate of hits or positive findings there. So it is a key vehicle that we need in the auditing business.

Mr. SHERICK. I think DCAA uses it on a regular basis. In fact, they have doubled their efforts in the last several years.

Senator BINGAMAN. Let me ask about the lag time. You said there was 4 to 7 years lag time in getting these contracts audited?

Mr. SHERICK. Closing the final audit of overhead.

Senator BINGAMAN. What is that? I am not clear what you are saying.

Mr. SHERICK. As Senator Levin brought out, overhead is paid on an agreed rate. Then at the end of the contract, before we close it, we go back and audit the overhead to make sure that, by item, all of the items were specifically allowable. We close out the overhead with a final audit.

We close out the overhead from 4 to 7 years after the costs have been incurred.

Mr. HELM. I would say in general, Senator, that in terms of audits we are auditing 1982 and 1983 issues right now; 1984 has not been submitted, generally, for overhead, but in just the pure audit we do not have a significant time lag.

There are many reasons why there is a lag in actually closing out the contract. That may have to do with how quickly the contractor submits data, how quickly DCAA can do the audit. Additional information is oftentimes asked for. The contracting officer may delay in closing out the contract. Other litigation may delay further audit on a contract.

Senator BINGAMAN. If we have the certificate that we came up with this morning on overhead costs, this is prospective, as I understand it. I mean, that when claims are made in the future on contracts people will have to sign this certificate.

Is there anything that could be done with this type of certificate for contracts that have been signed some time ago and claims that are now in the pipeline?

If we have got a substantial backlog of these things, should the responsibility remain with the Government to go back and find the instances of overcharge that have occurred, or could we shift some of that burden to contractors before we close these things out and issue new contracts?

Mr. SHERICK. I would defer to DCAA on that.

Mr. NEWTON. We now have the False Claims Act provisions, where the contractor is submitting a cost which has not been incurred, for example. If there is something that is—in an environment where we apply the criteria that we have for our auditors for making referral for investigation, where there is a reasonable basis

or suspicion that a fraudulent statement has been made on it, we will make a referral over to the investigative organizations to proceed with the appropriate followup on that.

But regarding these overhead claims that are awaiting settlement and all, we have taken a great measure to protect the taxpayers' interests thereby withholding amounts that are reflective of estimates of what might be finally concluded as being the allowable amounts. And it is very unusual for the final settlement of an overhead to result in the contractor having to refund some money to the Government at that time.

It is generally, the money is being held by the Government through these estimated unallowables which are established as billing rates. There is a final overhead rate which is negotiated at the end, which might well be some years later on a major contractor. But from the very first year in which those costs are being incurred, there is also a so-called billing rate which is set between the Government and the contractor.

And I do believe that those billing rates have been adequately reduced to protect the Government.

Senator BINGAMAN. That is all. Thank you.

Senator QUAYLE. Senator Glenn?

Senator GLENN. Thank you, Mr. Chairman.

Mr. Sherick, you mentioned the fraud cases you have and I was interested in following up on that a little bit. You mentioned we have some soft armorplate and faulty parachute shroud lines. How were those turned up? Was it your investigation that did that or was that brought to your attention?

Mr. SHERICK. One of them was a hot line allegation that came to us on the armorplate. It said that the contractor was selling us armorplate that was about one-quarter the strength that the specification called for. It was marked, counterfeit marked really, that it was the armorplate we were ordering.

Senator GLENN. Was there a sampling procedure somewhere in this? The question obviously, is, how do we know that we do not have soft armorplate out there on tanks someplace and do not have faulty parachute shroud lines?

Mr. SHERICK. The armorplate was installed on the battleship *New Jersey*. There was not a quality assurance check. Fortunately, it was not installed in a place that made the ship vulnerable for its mission. It was also installed on a destroyer and it had to be removed at a significant cost to the Government.

We do not have the old inspectors the way we used to. The contractor signs a certificate that says, this meets your specifications, period. Basically that is how we put them in jail, it is signing the false certificate.

Senator GLENN. Do we not have a Government representative at these plants turning out armorplate, that checks these things for hardness and quality?

Mr. SHERICK. We do have quality assurance people that go into these plants. When we get involved in a fraud like this, we find that the contractor lays out good armorplate, for instance, for the inspector to see. Then after the inspector leaves the contractor replaces it with inferior armorplate.

This happens because, they're crooks, and what they are attempting to do is defraud the Department of Defense. In this case, the two individuals involved each were going to make $750,000 in commissions and profits on fraudulent contracts. The two individuals involved are now serving 10 years each.

Senator GLENN. That is a minimum, I hope.

Mr. SHERICK. The judge said it was not contract fraud, it was sabotage. He gave them both 10 years. So that is a deterrent.

The same way with the individual with the shroud line. I believe he is serving 3 years.

Senator GLENN. That is not enough.

Mr. SHERICK. In that case the prosecutor was a former paratrooper and the judge was a former bomber pilot. And I think the reason he only got 3 years was he had a bad heart. [Laughter.]

I think they said he had 3 years to live. [Laughter.]

Senator GLENN. They should have made it 6 in that case. [Laughter.]

One other thing the chairman was talking about a little while ago, on these different numbers of audits. And I know we are getting ahead of ourselves, but in testimony scheduled later this afternoon, a defense contractor will indicate that he has undergone 11 different audits or reviews or something over the last 4 months.

Are these all coordinated? This sounds uncoordinated, the way it is presented here. DCAA does one, Defense Logistics Agency, Deaprtment of Defense inspector general postaward audit of 18 contracts, Department of Defense inspector general compensation audit, Defense Logistics Agency employee and executive compensation review, Defense Logistics Agency Government property review, Naval Air Systems cost review, Defense Contract Audit Agency independent research and development and bid and proposal audit, Defense Contract Audit Agency postaward audit, Defense Contract Audit Agency cost system information request, Defense Logistics Agency purchasing system review.

That is 11 different ones in 4 months. Are these all necessary?

Mr. SHERICK. Most of these are not auditors. They are contract administrators. They are in a facility for a specific purpose, either looking at the contract itself or at the Government-furnished equipment that is in the plan, things of that sort.

But they are not my auditors or DCAA auditors. I think they take a very broad view of "auditors" and anybody that comes in from the Government as far as they are concerned is an auditor.

Senator GLENN. Just one other comment, Mr. Chairman. That is, many years ago a good friend of mine was the head of General Motors, and I remember that he said that their budget at General Motors was larger than all except 10 nations in this world, which I always thought—I think it was 10. It was 8 or 10, something like that.

And they have an auditing system and a followup and a contracting system that takes them right down to getting their dollars—their penny's worth—or they would not be competitive, they would be run out of business.

And I know you have a huge job and your testimony, that paragraph on page 8 of somebody's testimony here, is very, very impressive. Mr. Sherick, yours, where you have that paragraph about the

enormity of the business that you oversee, and that cannot help but be impressive. That has got to be one of the biggest jobs in the world, to comptrol or audit or inspector general that kind of a problem.

But can we—if you were starting over again or if we were trying to correct this problem once and for all into the future, knowing our defense budgets are not going to go down, would you go to something more like private industry's contracting procedures to make sure we get every nickel's worth out of every dollar spent or, are we on the best system now that we can have?

Mr. SHERICK. Well, I would go to competition. When you get real competition, you get good prices. In the same way General Motors is competing with Ford, if the contractors compete with each other they sharpen their pencils and the Government can get fixed price contracts. We can say, tell us what you want per airplane, period. Contractors will deliver it at that price and that is the end of the line.

When we do not have that kind of competition and we have the major investment in research and development, and basically we are the only customer we are buying relatively few items and are buying them over a long period of years; then we really have to go out and negotiate with people on the delivery.

You mentioned General Motors; a few years ago I talked to the head of their truck division and they said basically that our truck requirement was a drop in the bucket to them and that the way we bought them was crazy. It was perhaps 2 weeks of production for them annually. He could not understand why, if we needed 100,000 trucks we don't buy them all at one time instead of buying a few every year.

There is setup time for producing trucks, the company would have to set the tooling up. They have to run the line for 2 weeks, then tear it down; a major part of the cost was just that. He said: If you know how many trucks you want, buy them.

But we do not. We buy just a few each year, and that is the way we do a lot of things.

Senator GLENN. I know you cannot make a straight comparison with private industry. I understand that, because we have a lot of special requirements and R&D and you are developing the state of the art, and there is a lot of different overhead involved with that. So I am very much aware that you cannot make a straight across-the-board comparison with private industry.

Mr. SHERICK. One of the other things you have to remember, too, Senator, is that we are always concerned about our mobilization base. We always have to have the capability to all of a sudden turn that thing on. That is one of the things we buy and we pay for it.

Senator GLENN. Thank you, Mr. Chairman.

Senator QUAYLE. Thank you, Senator. And thank you, gentlemen.

The witnesses for our second panel today are Mr. Richard Singleton, appearing on behalf of the American Electronics Association, and Mr. Richard Sauber, appearing on behalf of the Electronic Industries Association.

And Senator Glenn has asked that the statistics on the contract costs for the F-16 part be included in the record, which it will be.

OK, Mr. Singleton.

STATEMENT OF RICHARD SINGLETON, APPLIED TECHNOLOGY DIVISION, LITTON INDUSTRIES, ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. SINGLETON. Mr. Chairman and distinguished members of the Senate Armed Services Committee. It is my honor to address you on behalf of the American Electronics Association regarding current Department of Defense audit review issues. My name is Richard Singleton and I am manager of government financial relations and accounting for Applied Technology Division of Litton Industries.

My responsibilities at Applied Technology include the establishment of direct labor and overhead forward pricing rates and negotiations of ceilings for independent research and development and bidding proposal expenses. It is also my responsibility to be the principal interface with Government representatives conducting postaward audits and other operations reviews.

Applied Technology develops and manufactures radar warning systems for both the Air Force and the Navy, as well as some of our NATO allies.

I am here on behalf of the American Electronics Association, which represents more than 2,800 member companies of all sizes, encompassing all segments of the electronics industry. The comments I offer on behalf of the AEA membership represent this industry's perspective on the current state and effectiveness of DOD audit actitities.

It is certainly our opinion that audits are an important and necessary part of the overall defense procurement process. However, the current approach to the audit of defense contractors is often misguided, redundant, or completely unnecessary. The ultimate result of such activities is increased costs, both within the Department of Defense and to the defense contractors as well.

My division has undergone 9 audit activities over the last 4 months in addition to what I would consider routine Defense Contract Audit Agency and Defense Logistics Agency audits, including the Department of Defense Inspector General postaward audits of 18 contracts at the latest count.

Basically, the audit process starts with the contractor's proposal, which is reviewed for reasonableness, accuracy, and completeness. The auditor's report is then used by the contracting officer as one basis for negotiation. Once the contract is awarded, it is a necessary audit responsibility to test the supplier's accounting records to assure that the Government reimburses only those costs properly allocable to the contract.

With this basic process we find no fault. It is our opinion, however, that this process has been interrupted as a result of reactions to the recent severe criticisms of defense spending, contract management, and audit effectiveness.

These problems can be identified by addressing several major audit activities, including proposal audits, postaward audits, and operations audits. The proposal audit is a necessary prelude to the negotiation process. It is not unusual for a contractor to deal with

three separate agencies in the audit fact-finding process. Included would be Defense Contract Audit Agency, Defense Logistics Agency pricing analysts, and procuring agency pricing analysts.

While these organizations generally coordinate audits, there are on occasion redundancies in audit activities, as well as in requests made of the contractors. Even more importantly in our view, this important proposal audit activity has recently been subordinated to postaward audits and operational audits.

As a result, the contractor must often update the proposal and then subject the revision to auditors for review before negotiations. If proper attention were given to the original proposal, procurement costs would be reduced by eliminating the repetition of the proposal update efforts.

The Department of Defense is increasing postaward audit activities. Government audit agencies are using postaward audit to uncover waste, fraud, and abuse in the contracting process. In the past year, the Department of Defense inspector general has initiated its own postaward audits on a larger scale than was previously evident to industry. Unlike the Defense Contract Audit Agency, which normally audits a single contract at any time, the inspector general audit team typically audits a number of contracts at once.

Combined activities of these agencies can place tremendous hardship on the ability of the contractor to respond, since audit support necessitates the use of limited contractor resources. To date, the increase in postaward audits has resulted in relatively few findings, in our opinion, of waste, fraud, or abuse. However, by the establishment of this adversarial, investigative role by Government auditors, increased resources must be expended by the contractor to adequately respond to auditors' requests and allegations. If this level of postaward audit activity continues over the long run, contractors can be expected to hire additional personnel to support such Government reviews.

Our association is aware that Government auditors will be placing added emphasis on overhead cost control. This is one example of increased operations audit activity. This program was discussed in a recent letter from Deputy Secretary of Defense Taft to AEA President Ferrey. In short, the Taft initiatives outline a course of action whereby, in our opinion, Government representatives will attempt to be active participants in planning and control of contractor overhead costs.

It is our belief that the control of contractor overhead costs should be the sole responsibility of the contractor. Secretary Taft's initiatives ignore the independence that the contractor must retain if the Department of Defense is to obtain the benefits of competition. The Department of Defense should limit its involvement to evaluation of the reasonableness of costs and assurance that the actual expenses charged to the Government contracts are properly allocable and allowable by regulation.

Our observation is that the Government is not now adequately staffed, both in numbers of auditors and experience, to effectively carry out even the basic audit roles which I outlined earlier. This fundamental philosophical change from a free capital, entrepeneurial defense industry would only add to the problem. If certain industries are deemed to be captive quasi-State companies, to be

managed by the Department of Defense, that determination should be limited and not broadly applied to the entire industry.

Government operation audits by the Defense Logistics Agency teams, often with Defense Contract Audit Agency support, assess various contractor operations and then issue findings and recommendations for improvement. These reviews encompass, among others, the following areas: Compensation, automated data processing, purchasing systems, Government property systems, accounting systems, and independent research and development, and bid and proposal plans.

We are sure that some of the information obtained is useful to the Defense Logistics Agency. However, we believe that the Government should assess the cost versus benefit tradeoff of each of these activities to determine if the derived benefits equal the thousands of hours spent by both Government and contractor employees on any given review. From our perspective, in the long run these reviews often result in no meaningful redirection of previously established contractor systems or plans and no significant reduction in contractor costs.

Member companies of the AEA support the Department of Defense objective to reduce defense spending by eliminating abusive costs and inefficient or ineffective contractor practices through the close scrutiny which the audit and review process allows.

However, the increased audit activity which we have observed over the past year will most certainly result in additional costs both to the Department of Defense and its contractors if other less effective audits and review techniques are not eliminated in the process. The AEA proposes several ideas to improve the effectiveness of Department of Defense audit and review activities:

First, the Department of Defense should maxmize the use of the concepts established in the recent Competition in Contracting Act by taking advantage of a principal strength of the free enterprise system, that is, price reduction through competition. The Department of Defense would reduce the expense of the current audit and review process.

Second, the Department of Defense should endeavor to evaluate the reasonableness of contractor costs at a more summary level, rather than in greater detail as is the recent trend. For example, if employee benefits are reasonable overall, Defense Department auditors should not evaluate each element of benefits cost. No two companies are identical and within the boundaries of overall reasonableness company management is best able to determine the necessity of such expenditures.

Third, the Department of Defense should allocate more of its limited audit resources to proposal audits. It is in this proposal stage that the auditor is best able to support the entire procurement process. The proposal audit should be extensive enough to inform the contracting officer in the negotiation of a fair and reasonable price to the Government. Increased attention to this stage of the procurement process will not only allow the auditor to test the reasonableness of the estimate, but to evaluate its intrinsic value as well.

Fourth, the Department of Defense should limit its use of postaward audits in fixed price contracts to instances of suspected

fraud. At the present time, postaward audits are being used to negotiate in retrospect lower contract prices by taking advantage of what we consider to be an acceptable margin of error built into the complex Department of Defense proposal system.

These audits serve to demotivate the contractor working to be more efficient, only to give up the savings in a postaward audit. They also threaten to turn the procurement process into an adversarial environment.

In conclusion, the American Electronics Association supports the ultimate objective of the Department of Defense audit functions, to eliminate excessive costs. In doing so, the AEA recommends that competition, rather than audits, be used as much as possible to reduce contract price. Our members further recommend that ineffective audits be reviewed and eliminated and the resources be reallocated to the greatest benefit of the contracting officer, which we believe to be proposal audits.

Proposal audits should be conducted in a timely manner, to an extent necessary to convince the contracting officer of the fair and reasonable price. Audits and reveiws of overhead costs and contractor operations should be limited to tests of reasonableness, allowability, and allocability, without unnecessary micromanagement which conflicts with contractors' management plans and prerogatives.

And finally, postaward audits should be used to substantiate suspected contractor fraud or abuse, and not as an attempt at contract price reduction which takes from the contractor its motivation to be increasingly efficient.

Thank you for your time.

[The prepared statement of Mr. Singleton follows:]

PREPARED STATEMENT OF RICHARD SINGLETON, APPLIED TECHNOLOGY DIVISION OF LITTON INDUSTRIES ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

SUMMARY

Government audit and review activities are an important and necessary part of the overall defense procurement process. However, the increasing number of audits being conducted by various government agencies is placing unnecessary burdens on government contractors, leading to increased costs both to the government and the contractor.

The recent trend in government audit and review activities reduces incentives for current government contractors to increase efficiency and reduce costs and, contrary to the interests of the government, will discourage other companies form seeking government contracts.

Audits and reviews of overhead costs and contractor operations should be tests of reasonableness, allowability and allocability without unnecessary micromanagement which conflicts with contractors' management plans and prerogatives.

The Federal government should assess the effectiveness of its many audit and review activities to determine if the benefits derived equal the thousands of hours spent by both Government and contractor employees on any given review.

AEA recommends four ways in which the Department of Defense may improve the effectiveness of its audit and review activities:

1. Maximize the use of competition;
2. Evaluate the reasonableness of contractor costs at a more summary level;
3. Focus limited audit resources at the beginning of contract negotiations;
4. Limit use of post award audits to instances of suspected fraud or abuse.

CASE EXAMPLES

An appendix to this testimony lists observations of seven AEA member companies regarding their recent audit experiences. These case examples provide useful in-

sights into the kinds of audit situations and problems faced by government contractors.

Mr. Chairman and distinguished members of the Senate Armed Services Committee, it is my honor to have the opportunity to address you on behalf of the American Electronics Association regarding current Department of Defense audit and review issues.

My name is Richard Singleton. I am Manager, Government Financial Relations and Accounting at Applied Technology Division of Litton Industries.

I am here on behalf of the American Electronics Association. AEA's 2,800 member companies encompass all segments of the electronics industries, including manufacturers and suppliers of computers and peripherals, semiconductors and other components, telecommunications equipment, defense systems and products, instruments, software, research and office systems. The AEA membership includes companies of all sizes from "start-ups" to the largest companies in the industry. Only a fraction of AEA members perform contracts or subcontracts for the Federal government. The greatest number of the AEA membership (71%) are small companies employing fewer than 250 employees. AEA member companies account for 63 percent of worldwide sales of the U.S.-based electronics industries.

Currently employing 2.5 million Americans, the electronics industries are among the fastest growing in the economy. Already, the electronics sector constitutes the largest single manufacturing industry in the United States. Its payroll of over $50 billion provides more than $7.5 billion of federal payroll revenues.

The comments which I offer on behalf of the AEA membership represent this industry's perspective of the current state and effectiveness of Department audit activities. While the examples I will discuss are taken in large part from my own recent experience, they are generally throughout our industry. It is certainly our opinion that audits are an important and necessary part of the overall defense procurement process. However, the current approach to the audit of defense contractors is often misguided, redundant, or completely unnecessary. The ultimate results of such activities is increased cost, both within the Department of Defense and to the defense contractors as well.

FREQUENT AND REDUNDANT AUDITS COST TIME AND MONEY

The following list indicates the current level of government audit and review activities which my division has undergone over the past four months.

1. Routine Defense Contract Audit Agency efforts;
2. Routine Defense Logistics Agency efforts;
3. Department of Defense Inspector General Post Award Audit of 18 Contracts;
4. Department of Defense Inspector General Executive Compensation Audit;
5. Defense Logistics Agency Employee and Executive Compensation Review;
6. Defense Logistics Agency—Government Property Survey;
7. Naval Air Systems Command Should Cost Review;
8. Defense Contract Audit Agency Independent Research and Development and Bid and Proposal Audit;
9. Defense Contract Audit Agency Post Award Audit;
10. Defense Contract Audit Agency Cost System Information Request; and
11. Defense Logistics Agency Purchasing System Review.

Government auditors have an important role in the procurement process. Basically, the contractor's proposal is reviewed for reasonableness, accuracy and completeness. The auditor's report is then used by the contracting officer as one basis for negotiation. Once the contract is awarded, it is a necessary audit responsibility to test the supplier's accounting records to assure that the Government reimburses only those costs properly allocable to the contract. With this basic process, we find no fault. It is our opinion that this process has been interrupted as a result of reactions to the recent severe criticisms of defense spending, contract management and audit effectiveness. These problems can be identified by addressing the major audit activities including proposal audits, post award audits and operations audits.

PROPOSED AUDITS

The proposal audit is a necessary prelude to the negotiation process. It is not unusual for a contractor to deal with three agencies in the audit and fact finding process. They are the Defense Contract Audit Agency, the Defense Logistics Agency pricing analysts and the procuring agency pricing analysts. While these organizations generally coordinate audits, there are, on occasions, redundancies in audit activities as well as requests made of the contractors. Even more importantly, in our view, this important proposal audit activity has recently been subordinated to post

award and operational audits. As a result, the contractor must often update the proposal and then subject the revision to auditors for review before negotiations. If proper attention were given to the original proposal, procurement costs would be reduced by eliminating the repetition of the proposal update efforts.

Also, proposal updates to undefinitized letter contracts subject the contractor to defective pricing allegations during post award audits since it is difficult and costly to accurately update a proposal with actual cost or purchase commitment information on a "real time" basis once the contract is underway. The contractor is then pressured to negotiate contracts with marginal profits once the cost risk element has been eliminated, although negotiations may be otherwise limited by a letter contract containing a "not-to-exceed" ceiling beyond which the contractor bears all the risk.

POST AWARD AUDITS

Government audit agencies incresingly are using the post award audit to uncover waste, fraud and abuse in the contracting process. In the past year, the Department of Defense Inspector General has initiated its own post award audits on a larger scale then was previously evident. Unlike the Defense Contract Audit Agency, which normally audits a single contract at any time, the Inspector General audit team typically audits a number of contracts at once. The combined activities of these agencies can place a tremendous hardship on the ability of the contractor to respond since audit support necessitates use of limited contractor resources. To date, the increase in post award audits has resulted in few findings of waste, fraud or abuse. However, with the establishment of this adversarial investigative role by Government auditors, increased resources must be expended by the contractor to adequately respond to auditors' requests. If this level of post award audit activity continues over the long run, contractors can be expected to hire additional personnel at increased costs to the contractor, and ultimately the government, to support such government reviews. We also take note that the Inspector General is adding approximately 2,900 auditors to its staff. AEA believes that such resources would be better placed in support of the up front proposal audit process.

OPERATIONS AUDITS

It has come to our attention that government auditors (as well as other Department of Defense representatives) will be placing added emphasis on overhead cost control. This is one example of increased operations audit activity. This program was discussed in a recent letter from Deputy Secretary of Defense, William H. Taft, IV, to AEA President, E.E. Ferrey. In short, the Taft initiatives outline a course of action whereby, in our opinion, government officials will attempt to be active participants in the planning and control of contractor overhead costs. It is our belief that control of contractor overhead costs should be the sole responsibility of the contractor. Secretary Taft's initiatives ignore the independence that the contractor must retain if the Department of Defense is to obtain the benefits of competition. The Department of Defense should limit its involvement to evaluation of the reasonableness of costs and assurance that the actual expenses charged to government contracts are properly allocable and allowable by regulation.

MORE EFFECTIVE ALLOCATION OF AUDIT RESOURCES IS NEEDED

Our observation is that the Government is not now adequately staffed, both in numbers and experience, to effectively carry out the basic audit roles which I have outlined above. This fundamental philosophical change from a free capital entrepreneurial defense industry would only add to the problem. If certain industries are deemed to be captive quasi state companies managed by the Department of Defense, that determination should be limited and not broadly applied.

Government operations audits by the Defense Logistics Agency teams, often with Defense Contract Audit Agency support, assess various contractor operations and then issue findings and recommendations for improving certain contract activities. These reviews encompass, among others, the following areas: compensation, automated data processing, purchasing system, government property system, accounting system, and independent research and development and bid and proposal plans. We are sure that some of the information attained is useful to the Defense Logistics Agency. However, we believe that the Government should assess the cost versus benefit tradeoffs of each of these activities to determine if the derived benefits equal the thousands of hours spent by both Government and contractor employees on any given review. From our perspective, in the long run, these reviews often result in no

meaningful redirection of previously established contractor systems or plans and no significant reduction of contractor costs.

The member companies of the American Electronics Association support the Department of Defense objective to reduce defense spending by eliminating abusive costs and inefficient or ineffective contractor practices through the close scrutiny which the audit and review process allows. Our members companies strive to return fair and reasonable profits to shareholders from revenues resulting from sales to the Department of Defense. We also want to maintain lasting, professional working relations with our customers, whether commercial or government. As such, we are willing participants in the defense procurement process, which includes those reasonable audits and reviews required by our customers. However, the increased audit activity which we have observed over the past year will most certainly result in additional costs to both the Defense Department and its contractors. More effective and efficient audit and review techniques are required if we are to avoid such increased burdens.

AEA RECOMMENDATION TO IMPROVE AUDIT AND REVIEW ACTIVITIES

The AEA proposes several ideas to improve the effectiveness of the Department of Defense audit and review activities.

1. Department of Defense should maximize the use of concepts established in the recent Competition in Contracting Act. By taking advantage of the principal strength of the free enterprise system—price reduction through competition—the Department of Defense would reduce the expense of the current audit and review process.

2. Department of Defense should endeavor to evaluate the reasonableness of contractor costs at a more summary level rather than at a lower, elemental level as is the recent trend. Although costs should be audited in sufficient detail to determine allocability and allowability, auditors should be able to see the forest through the trees. For example, if employee benefits costs are reasonable overall, Defense Department auditors should not be asked to evaluate each element of benefits costs. No two companies are identical, and, within the boundaries of overall reasonableness, company management is best able to determine the necessity of such expenditures.

3. Department of Defense should allocate more of its limited audit resources to proposal audits. It is in the proposal stage that the auditor is best able to support the entire procurement process. Proposal audits should be extensive enough to guarantee to the contracting officer the negotiation of a fair and reasonable price to the Government. Increased attention to this stage of the procurement process will not only allow the auditor to test the reasonableness of the estimate, but to evaluate its intrinsic value as well. It is at this time that costs can truly be reduced rather than by non-productive second guessing after the fact. At the same time, overall audit costs would be reduced by eliminating the costs of updating and re-auditing contractors' proposals held up due to the current slowness of the audit process.

4. The Department of Defense should limit its use of post award audits of fixed price contracts to instances of suspected fraud or abuse.

At the present time, post award audits are being used to negotiate, in retrospect, lower contract prices by taking advantage of what we consider to be an acceptable margin of error built into the complex Department of Defense proposal system. These audits serve to discourage the contractor working to be more efficient only to give up savings in a post award audit. They also threaten to turn the procurement process into an adversarial environment which discourages both current and potential contractors from doing business with the government.

CONCLUSION

In conclusion, the American Electronics Association supports the ultimate objective of the Department of Defense audit functions: to eliminate excessive costs. In doing so, the AEA recommends competition, rather than audits, be used as much as possible to reduce contract price. Our members further recommend that ineffective audits be reduced, and the resources be reallocated to the greatest benefit of the contracting officer, which we believe to be proposal audits. Proposal audits should be conducted in a timely manner, to an extent necessary to convince the contracting officer that the government is paying a fair and reasonable price for the goods and services the government procures. Audits and reviews of overhead costs and contractor operations should be limited tests of reasonableness, allowability and allocability without unnecessary micromanagement which conflicts with contractors' management plans and prerogatives. And, finally, post award audits should be used to sub-

stantiate suspected contractor fraud or abuse, and not as an attempt at retroacative contract price reduction which takes from the contractor much of its motivation to be increasingly efficient.

APPENDIX: OBSERVATIONS OF SEVEN AEA MEMBER COMPANIES REGARDING RECENT AUDIT EXPERIENCES

COMPANY NO. 1

(Company profile: $275 million sales; 33% defense; 4,000 employees)

Access to Records.—The Chairman and Chief Executive Officer of this AEA member company recently wrote to AEA regarding auditors' access to company records, a common problem defense contractors are facing recently.

"Certainly, we believe in and support the Government's right to audit direct and indirect costs allocated to Government Contracts, including the right to have access during such audits to records which cover costs incurred by internal auditors. However, this does not include access by DCAA to internal audit reports, which constitute a vital management tool. The Defense Contract Audit Manual, which establishes the working rules of the DCAA, acknowledges that the Government is not entitled to demand access to internal audit working papers and reports. Unfortunately, DCAA has chosen to ignore its own precepts and is seeking to audit and, therefore, exercise control over a contractor's management functions. Moreover, DCAA's actions are not only unauthorized, they also are unwise. By insisting upon unrestrained access to and use of a company's internal audit records and reports, the DCAA is creating a strong disincentive to the establishment and/or operation of strong internal audit departments—departments which are intended to serve the industry and the Government by ferreting out and correcting problems. Given the current emphasis on preventing fraud waste and abuse in Government contracts, this action by DCAA seems particularly shortsighted."

COMPANY NO. 2

(Company profile: 414 million sales; 95% defense; 150 employees)

Poor Management of Government Audit; Inconsistent and Conflicting Requirements Imposed on Contractor—

December 15, 1982: The Air Force issued a partial termination notice on an FFP contract to be effective upon delivery of work due in March 1983.

March 17, 1983: Company submitted DD540 settlement claim [for partial termination costs] with certification.

March 25, 1983: Company submitted revised DD540 as the [procurement contract officer (PCO)] has issued a contract and that affected the layout of the form.

March 29, 1983: Company submitted request for partial payment of settlement claim as allowed by DAR 8-213.1 and 7-203.21(b)(j).

April 4, 1983: [Procurement contract officer] gave authority to [Defense Contract Administrative Services (DCAS) contract officer (TCO)] to negotiate termination settlement.

May 4, 1983: Per TCO request, company submitted data to support partial payment request.

July 20, 1983: [Defense Contract Audit Agency (DCAA)] Auditor "A" visited, reviewed, asked for cost breakdown and explanation in a precise form.

September 20, 1983: Company provided requested data to DCAA and to the TCO.

April 4, 1984: Company discovered Auditor "A" was transferred and information lost. Company resubmitted response to DCAA.

June 11, 1984: Auditor "B" met to review claim—Auditor "B" asked for entirely different approach to cost data.

June-October 1984: Auditor "B" paid many visits to review claim. Auditor requested and company provided copies of numerous documents related to and unrelated to claim. Auditor demanded documents which the company prepared breaking down cost in myriad ways.

November 15, 1984: Auditor "C" arrived for "fresh start"—claimed that the boxes full of documentation provided to Auditor "B" were unknown (Auditor "B" had quit DCAA). We again rehashed claim with Auditor "C", providing documents similar to those requested by Auditor "A".

February 4, 1985: Auditor "D" arrived starting Auditor "C" was on special assignment and that he (Auditor "D") would stick with job to completion. Auditor "D" took on unique approach, requiring preparation of further cost documentation.

March 6, 1985: By telecon, Auditor "D" claims he will complete audit by March 30, 1985.

Conclusions: (a) No partial payment made by government on December 1982 termination; (b) A great deal of time and cost involved to provide information to the auditor.

COMPANY NO. 3

(Company profile: $100 million sales; 75% defense; 1,500 employees)

A. Lack of objectivity.—

(1) Arbitrary use of statistics to reduce our cost estimates.

Example: On several recent forward pricing overhead audits, DCAA has used regression analyses only on those items and data points which resulted in lowering our projected overhead rate and ignored those that raised our rates.

(2) Taking extreme negative positions without regard for sound business decisions and acceptance of appropriate facts.

Example 1: Both our external auditors (CPA firm) and internal auditors agreed that a 15 year life was acceptable for a building improvement based on generally accepted accounting principles. DCAA used 37 years and refused to change even after our largest customer (Air Force) accepted the 15 year life in their negotiations.

Example 2: DCAA would not change their estimate of utility rate increases in our overhead rate projections even after a large subsequent increase by the utility was demonstrated.

Example 3: DCAA would not allow any overhead recovery on a proposed building expansion in another State even after demonstrating lower cost to the Government through lower labor rates and lower land costs in the other State. The expansion was necessary due to a large increase in our DOD backlog and the need to reduce delivery delinquencies on current Government contracts. DCAA refused to change their position even after the DCASMA [Defense Contract Administrative Services Management Area] pricing chief disagreed with their findings.

B. Not allowing rebuttal during exit conferences.—Example: Forward pricing exit interviews consist of DCAA presenting their findings without allowing rebuttals other than for obvious errors. Their position is that any rebuttals regarding the audit must be presented to and negotiated with the PCO.

C. Lack of Management by DCAA Superiors.—DCAA field auditors frequently issue reports which reach incorrect or rebuttable conclusions. It is the reponsibility of these auditors' superiors in DCAA to review these reports and to provide further input if necessay. However, DCAA management officials appear to "rubber stamp" their auditors' reports, leaving no recourse for contractors' appeals. This lack of oversight by DCAA managers not only reduces the credibility of the DCAA managers, but also the field auditors actually performing audits.

COMPANY NO. 4

(Company profile: $128 million sales; 92% defense; 1,700 employees)

A. Duplication of Audit Effort.—We have noted a propensity for the Department of Defense auditing agencies (the Defense Contract Audit Agency (DCAA), the Inspector General (IG), and the audit groups of the Defense Contract Administration Service (DCAS)) to duplicate each others efforts. For example, contractors are currently having their compensation systems reviewed by all three of these agencies. Each agency is asking similar questions and requesting similar data. In the past, all such compensation system reviews were conducted by DCAS teams who specialized in this area. We have noted that the DCAA and IG auditors displaced much less knowledge about this area than the DCAS auditors. In fact, the DCAA auditors had apparently attended only a one-week training course which qualified them as "experts" in this complex area.

We see little justification or benefit from the Government's use of three agencies to do the work of one and believe that the limited amount of available audit time could be spent in more productive ways than in duplicating the work of others.

B. Failure of Agency to Comply with own regulations.—Certain Department of Defense audit agencies are failing to follow their own regulations during the course of their audit. Complaints to appropriate supervisors have not caused the return to compliance with the agency regulations. We are concerned that audit agencies are flouting their own regulations in their zeal to "get" contractors. Agency regulations were promulgated for a purpose and both the Government and contractors benefit from the Government's compliance with it's own regulations.

C. Inconsistency in regulation application.—A Government contractor with several offices, even in the same city, can encounter some serious problems if the offices are audited by different branch offices of the audit agencies such as the DCAA. We have been informed that different branch offices of DCAA or DCAS Management Areas

interpret regulations, such as the Cost Accounting Standards (CAS), quite differently.

One example of widely differing interpretations is that of CAS 410.50(j) which allows the use of lower General & Administrative (G&A) expense allocation rates for any contract which receives significantly less than normal benefits from the G&A expense. Within a single company whose units are audited by two different Management Areas, we have discovered two substantially different interpretations for this standard. One DCASMA interprets the standard as it is written while the other interprets the standard quite differently, saying that any situation which does not exactly match the illustration of CAS 410.60(g) would not qualify for the lower G&A rate.

We are extremely concerned that such different interpretations of regulations by Government auditors could cause contractor inefficiencies since contractors would have to follow different regulations at different locations. Since these inefficiencies would be passed on to the Government in the form of higher prices, the audit agencies would be contributing to higher prices for Government contractors by their failure to consistently interpret Government regulations.

D. Inadequate Training and Experience.—We have noted that the general level of competence has been consistently trending downward for at least the past five years, if not the past ten. For various reasons, the more capable auditors leave the Government for industry. While compensation is a factor, it is our impression that the work environment, lack of respect by one's peers, and other qualitative factors are causing this turnover.

COMPANY NO. 5

(Company Profile: $100 million sales; 65% defense; 850 employees)

A. Auditor to Company Data.—DCAA frequently insists on obtaining internal company information to which they are not entitled. For example, DCAA has demanded catalog cost information which is confidential. Government auditors need to pay more attention to their own audit guidances and regulations and abide by them when they are in the field conducting audits.

B. Prime Contractors Conduct More Comprehensive, Shorter Audits.—The problems we face with government audits do not exist when we are audited by prime contractors. In fact, prime contractors have a responsibility to audit their subcontractors, unless the subcontractor refuses.

Primes' audits generally are more efficient, more professional, and take less time and money to comply with, all the while saving the government expenses associated with their audits. The reason that primes' audits can be more comprehensive and take a shorter time to complete is that primes understand the business better than most government auditors.

Government audits should place more emphasis on general audits regarding allowability and allocability, rather than focusing attacks on specific items such as public relations costs, advertising, air travel, meals or other individual elements.

C. Competence.—Audits should benefit both the contractor and the government by addressing situations objectively and providing conclusions based on the application of audit principles and regulations to given facts. The information provided by such audits can increase contractor efficiencies which can reduce the price the government pays for items it procures.

Prime contractors identify quantitatively areas to address in contract negotiations based on actual data they reviewed in audits. Using this data, they then cite a specific rule, relate it to specific data, and draw appropriate conclusions.

DCAA audits, on the other hand, do not necessarily follow such a logical pattern. They frequently have "questioned" certain data without providing either the facts from which they have drawn their conclusion or the regulation to which they have applied the data they have found. Sometimes they have cited incorrect "reasons" for reaching their "conclusions." Such efforts do not benefit the government or the contractor.

COMPANY NO. 6

(Company Profile: $125 million sales; 100% defense; 1,200 employees)

A. Duplication of Audit Effort.—Frequently we comply with prime contractors' audits only to be audited again when the prime's administrative contract officer (ACO) requests DCAA opinion of the prime's audit. What makes the problem worse is that the prime's audit generally is more thorough and has been used in subsequent contract negotiations. Thus, when DCAA arrives to audit the prime's audit, they not only take more time to conduct their audit, but they delay a contract

which may already have been negotiated. This costs us, the prime, and the government time and money.

B. Attitude Problems.—In an audit of a development contract we were negotiating with the government, DCAA disallowed 80 percent of our engineering costs—a phenominal conclusion which they intuitively should have questioned themselves. When we showed them the error (which admittedly was caused by a clerical mistake for which we were responsible) they were totally inflexible. We were forced to go back and request another complete audit even though the error was obvious and easy to correct.

C. Confidentiality/Using Information for Unstated Purposes.—The DoD Inspector General (IG) requested DCAA to audit information which technically was not subject to audit (company profit information and data related to contracts under $500,000). We were informed that this information was not going to be used for any other purpose than to provide background data for the IG. In a spirit of cooperation, we provided all the information the auditors requested.

Later, however, other DoD Services came to us requesting adjustments for "excess profits" on selected parts, based on information provided earlier to the IG. Additionally, the Services only requested adjustments on those items on which they determined we made excess profits. They did not attempt to seek adjustments on those items on which we lost money. Even though we have changed our pricing policy on those items in which the government believes we have made high profits, the government appears concerned only when we make money, not when we lose it.

Another example of this lack of concern involved an IG audit requested by the Naval Air Systems Command on updated equipment for one of the Navy's planes. The auditor opened our books on one update part and found that we lost $1 million. He promptly closed the book and performed no further audit on that part.

D. Slowness of Government Audits.—We must negotiate rate packages which affect several contracts being negotiated by our company concurrently. Negotiation of such rate packages usually takes between one and two weeks when we work with the prime contractor; but the same negotiations take six to eight weeks with government auditors. These delays therefore slow down our ability to perform all contracts we are working on which require such a rate package.

COMPANY NO. 7

(Company Profile: $45 million sales; 50% defense and other government; 600 employees)

A. Overlapping, Frequent Audits.—We are continually audited by a number of agencies. In addition to frequent DCAA audits, the Defense Contract Administration Service Management Area (DCASMA) auditors review our quality control systems, government property system, small and disadvantaged business program, and field expediting program. The Defense Contract Administration Service Region (DCASR) office meanwhile reviews our compensation program, insurance and retirement plan, and our procurement system.

B. Conflicting Requirements.—DCASMA employs its own pricing methodologies which frequently conflict with those used by DCAA. For example, if we want to make a modification in a pricing plan, we first need to approach the administrative contract officer (ACO). The ACO will consult his own pricing group which reviews our proposal. The ACO will then consult with DCAA, which often takes an entirely different approach to the proposal.

Senator QUAYLE. Thank you, Mr. Singleton.

Mr. Sauber?

STATEMENT OF RICHARD A. SAUBER, ESQ., OF FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, ON BEHALF OF THE ELECTRONIC INDUSTRIES ASSOCIATION

Mr. SAUBER. Thank you, Mr. Chairman.

I would like, if possible, to submit my remarks for the record and summarize them if I could in the interest of time.

Senator QUAYLE. Your entire testimony will be put in the record. You may proceed.

Mr. SAUBER. Thank you.

I am Richard Sauber, counsel to the law firm of Fried, Frank, Harris, Shriver & Jacobson. I am testifying today on behalf of the Electronic Industries Association. Many of the 450-member companies of the association provide defense electronics products, equipment and systems to the Department of Defense, and it is on their behalf that I appear before you today.

I will not try to duplicate the efforts of my colleague here, but I would like to say that I think the association has, with respect to the IG and the DCAA, a number of suggestions and goals that follow certain themes. First, we think that the inspector general should perform the function of reviewing the operation and the effectiveness of other DOD components, that that is clear, that there is statutory authority and something that clearly needs to be done.

The second thing the IG can and should do and is doing is to conduct thorough and effective criminal investigations involving serious allegations of wrongdoing on the part of contractors or government personnel.

I think the difficulty in some of the concerns raised here today is where the lines of authority between the inspector general and the Defense Contract Audit Agency begin to blur, where the IG finds himself making procurement policy or audit policy as opposed to reviewing what DCAA is doing.

I think there is another issue that we have highlighted in our submission, and that is access to records. And it really, I think, goes back to a point that Dick just made about cost benefit analysis, and this applies I think to one specific kind of access to records that I can use as an example, and that is the companies' internal audit reports, which has become an issue recently.

I am a former Federal prosecutor, and when I was in the Department of Justice focusing on the problem of defense procurement criminal cases we had as one of our goals, convincing the industry to perform a strong self-policing function, that there was simply no way to audit every submission or investigate every kind of allegation, and we were really relying in many ways on companies policing their own operations.

And it was to foster that kind of procedure, that was one of our specific goals. The internal function is directly related to that kind of effort, and the automatic access by DCAA auditors to that sort of report I think in our judgment may tend to water down the effectiveness of the effort and may lead—and I think we are seeing it now—to companies taking the position that they still want to do internal audits, but they are going to put them now under the auspices of inside general counsel or outside counsel, so that the information will be protected by the attorney-client privilege.

And that can only increase the kinds of costs that I think this committee has addressed itself to. We have, in reference to those problems, three sort of general conclusions and recommendations.

One is that DCAA, as the principal contract audit agency within the Pentagon, should have and maintain jurisdiction as the sole audit authority in the areas of cost pricing and verification of the adequacy of internal controls directly pertinent to contract performance.

And the second item as a theme that we would like to urge on the committee is that, district lines should be drawn and maintained between the audit and investigative functions.

And finally, that the Department of Defense inspector general should have a strong oversight and review function, but should rely on other DOD organizations to make and implement procurement and audit policy.

That is essentially a summation of our remarks, and I would be happy to answer whatever questions you might have.

[The prepared statement of Mr. Sauber follows:]

PREPARED STATEMENT OF RICHARD A. SAUBER, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, ON BEHALF OF THE ELECTRONIC INDUSTRIES ASSOCIATION

Mr. Chairman and Subcommittee Members: I am Richard Sauber, of counsel to the firm of Fried, Frank, Harris, Shriver and Jacobson. I am testifying today on behalf of the Electronic Industries Association (EIA).

Many of the 450 member companies of the Association provide defense electronic products, equipments and systems to the Department of Defense and it is on their behalf that I appear before you today.

INTRODUCTION

The overall goal of our efforts in defense procurement is to obtain the best possible goods and services for the lowest possible cost. In analyzing this effort and the problems facing this Subcommittee, it might be helpful to start with certain premises and proceed from there to identify those areas which might warrant improvement.

We can start with the premise that both the taxpayers and the contractor community think that the Defense Contract Audit Agency ought to be able to conduct effective, competent and thorough audits. I think we can also agree that having a strong and effective Inspector General within the Defense Department is beneficial for two specific reasons: (1) The IG should perform the function of reviewing the operation and effectiveness of other DoD components, and (2) The IG should be able to conduct thorough and effective criminal investigations involving serious allegations of wrongdoing on the part of contractors or government personnel.

Many of the problems raised by industry and which we will discuss today stem in large measure from a perceived blurring of the lines between the functions of DCAA and of the IG. A blurring of those lines and a confusion about the respective responsibilities of the two organizations can in my judgment lead to a diminution of the effectiveness of each. In many ways the issues raised at the last hearing by Mr. Pownall and Mr. Anderson can be reduced to a concern about the blurring distinction between audits and investigations.

There is also another premise that I would like to raise before delving into some of the specific issues. We can assume, I trust, that it is in the interests of the United States to reduce the costs associated with doing business with the government. And as I will discuss in more detail as we go through these issues, reducing the cost of doing business with the government means reducing the amount of money that contractors spend of necessity when they get involved in such issues. And by keeping down the cost of doing business with the Government, we not only help the Treasury, we also lower barriers of entry into DoD contracting and encourage new companies to compete for contracts.

I.

The first issue concerns the duplication of audit functions by government agencies. It seems to me that this is a problem quite easily remedied and alleviated by some coordination between government audit functions. Such DoD organizations as the IG, DCAA, the Defense Contract Administration Service, and the audit components of individual military departments, ought to be able to coordinate their activities so that duplicative efforts are not undertaken. Duplication of audit functions merely means more work for lawyers and accountants and more charges to overhead much of which is reimbursed by the Government. Audits can disrupt a contractor's effective functioning and result in a slowed-down work pace.

In my own experience, many of the duplicative functions arise not just because of a lack of communication but because of a disagreement over policy matters. For in-

stance, the information concerning compensation of contractor personnel is probably in every instance already within the hands of some governmental and probably DoD agency. That agency may have made a decision about that data which another agency disagrees with. Rather than take the issue on head first and get access to the underlying data so as to dispute policy decisions, the other agency may insist on doing its own audit to go over the same well-plowed ground yet a second or third time. Prior to the time that a DoD agency undertakes an audit it might be a good idea to insist that the agency make a check within DoD to make sure that the data being sought does not already exist within the government.

II. ACCESS TO RECORDS

There is no question in my mind, and I think in the minds of most knowlegeable people within the industry, that DCAA ought to have complete access to all documents sufficient to reflect direct and indirect costs and all documents related to the negotiation, pricing, or performance of a contract. Without such access doing complete audits in furtherance of the DCAA audit mission may not be possible.

But the audit clause by which DCAA gains access to records is not unlimited. It's precise definition may be the subject of past and future court battles but I think it's clear that the Supreme Court has decided that the breadth of the access clause is not coextensive with a company's entire file of documents. The question then becomes: What makes sense for DCAA to review both in terms of its own mission and in terms of the interests of the United States?

The most current topic in this regard is DCAA access to internal audit reports. In our view, such automatic access by DCAA may, in fact, be contrary to the taxpayers' interest for some very basic reasons. I know from first-hand experience that when we set up the Special Fraud Unit in the Justice Department three years ago, we had as one of our goals the encouragement of self-policing practices by the industry. We specifically hoped that companies would set up and establish strong internal audit procedures where by problems could be identified and companies could rectify them. We recognized that deterrence, in the form of industry self-policing, was an important as specific prosecutions.

Automatic access by DCAA auditors to these internal audit reports may limit the extent to which management and company employees are frank with internal auditors. Once it becomes certain that the information developed by internal audit will be routinely available to or handed over to DCAA auditors, I fear that the effectiveness of the internal audit process will be severly diminished.

What is likely to be the result of a right by DCAA to get unlimited access to internal audit reports? I think there will be two outcomes, the beginnings of which we are already seeing. First, companies will simply end their strong self-policing activities. This would be a tragedy for the industry and the taxpayers. Second, some companies who still desire to conduct strong internal investigations will redesign the entire process so that the internal audit is conducted by lawyers and is consequently protected by the attorney-client privilege. Once again, this increases the ultimate costs paid by the taxpayers. It doesn't have to be so.

Does this mean that we are supporting here today the proposition that companies ought not to turn over damaging information to the government? No, of course not. Many companies, even when the information is protected by attorney-client privilege, have made full and voluntary disclosures about severe internal problems to the Department of Defense. The issue is how can companies in the first instance most effectively gather information about what is happening in their organizations in order to find our precisely what the facts are.

DCAA access to a whole range of other kinds of financial and business planning records seems unnecessary for a number of different reasons. These documents generally appear not to have anything to do with either cost and pricing data or documents of original entry to determine the effectiveness and accuracy of a company's accounting system. Under a DoD memorandum of January 17, 1983, issued by then Assistant Secretary Shillito, DoD has concurred that where budgets and forecasts are concerned, its rights properly can be limited:

"There are certain restrictions which we believe can justifiably be placed on access to certain data under normal operations conditions. Sales dollars are unnecessary if cost of sales and units of production or similar volume type data are available. Forecasts or predictions concerning outstanding claims or future negotiations, market strategies, forecasts of profits, analyses of competitive positions, and pro forma projections are not required in the reviews of price proposals, costs incurred, or defective pricing. However, some of these data may be required in times of ex-

treme financial problems which might adversely affect Government contracts, advance funding or guaranteed Government loans."

III.

The line drawing between the IG and the DCAA functions was explicitly recognized by Congress when it refused to include the DCAA within the offices of the DoD IG. The only DoD organization having the responsibility to conduct contract audits is still the Defense Contract Audit Agency, the agency best able to conduct such audits. As a taxpayer, I think it is in my interests to have the DCAA conduct its audit functions in the best and most efficient manner possible. This necessarily means that DCAA has to maintain good professional working relationships with contractors. The cooperation of contractors and the give-and-take between DCAA auditors and contract officials has been and is a necessary element in ensuring that DCAA can do its job most effectively.

To foster this kind of working relationship contractors must be clear that they are dealing with contract auditors and not criminal investigators when they deal with DCAA. To the extent that there has been some blurring of these lines it has, in our judgment, redounded to the detriment of the United States by placing limitations on the effectiveness of the DCAA auditors. If companies are unclear about whom they are really dealing with, they will expect and act as if the worst has happened and that they are the subject of a criminal investigation. That assumption will slow the process down, will create more work for lawyers, and will result in a suspicion on the part of the individual employees who may be the subject of interviews or discussions with DCAA about what their rights are and what they should or shouldn't say. This is not the kind of atmosphere best suited for the type of contract audits which would most benefit the United States.

The perception among contractors that the lines have been blurred is not a wild flight of fantasy. One need look no further than the Westinghouse case. What is really happening in Westinghouse is that the Inspector General has indicated that he will use his subpoena power to enforce DCAA's interpretation of the audit clause. This is in our judgment not the right message to be sending and suggests that the IG's investigative tools will be utilized to benefit DCAA. More importantly, it suggests that DCAA will become an extension of the IG and his mission.

In fashioning some rules about having clear-cut differentiation between the auditors and the investigators, it might be instructive to look at the IRS area where a rather expansive body of law has developed concerning the difference between civil audits and criminal investigations. I think it is in that area of developing safeguards that the entire process might be improved.

We would like to add another item where the blurring of lines of authority also occurs at times. The IG and procurement policy functions in the Pentagon have recently overlapped in a number of instances. The IG's oversight function should not, in our view, expand to encompasss policy formulation. There are highly trained and exceedingly competent procurement officials at DoD who have the responsibility for formulating and implementing policy on defense procurement. These professionals should be enouraged to make policy—there performance can then be reviewed by the IG.

CONCLUSIONS AND RECOMMENDATIONS

Where does all this put us in terms of conclusions and recommendations? First, it is important to recognize that the Defense Contract Audit Agency is an extremely well run and effective organization. It is perfectly capable of conducting contract audits that are fully consistent with the interests of the United States, fully protective of the taxpayer's dollar. The Agency's access to contractor records is delineated by the access to record clause in most DoD contracts. The extent and breadth of that clause ought to be left to either negotiation between DCAA and the contractors or in appropriate cases, to litigation of that issue. The idea advanced in some quarters that DCAA is soft on contractors is from my personal experience with the Agency and with contractors simply not true.

There is clearly a role for the Inspector General in assessing the effectiveness of DCAA. That role would include a review of DCAA functions, review of DCAA policies and procedures, and a review of DCAA results. It is not in our judgment for the Inspector General to use his powers to enhance or enforce either the audit rights or make audit policy for DCAA. It is that kind of crossing over the line that leads to an increasingly hostile relationship between contractors and auditors and increasingly less effective audit function. Ultimtely, it is the taxpayers who will pay the bill for higher costs.

So, too, it is clearly within the Inspector General's purview to conduct vigorous criminal investigations of serious allegations. The IG has the resources and the will to investigate these allegations. That mission is very different from the contract audit mission, and recognizing the difference will enhance the effectiveness of each.

In sum, EIA recommends the following:

1. The DCAA should have and maintain jurisdiction as the sole audit authority in the areas of cost, pricing and verification of the adequacy of internal controls directly pertinent to contract performance.
2. Distinct lines should be drawn between audit and investigative functions.
3. The DoD IG should have a strong oversight and review function, but should rely on other DoD organizations to make and implement procurement and audit policy.

Mr. Chairman, this concludes our formal presentation. I would be glad to answer your questions.

Senator QUAYLE. You say that you do not think that DCAA and others sought to have access to the internal audits that you do, is that what you said?

Mr. SAUBER. Yes; I think that—let me answer this in two ways. I think that automatic access by Government auditors to those kinds of reports will tend to water down the effectiveness of the company's internal investigative function.

Those reports, I should say, whenever there is a Federal criminal investigation of a company involving allegations of procurement fraud, the internal audit reports are the first things that a prosecutor subpoenas and reviews. And generally, they are simply not helpful. So, it is not a quesiton that the Government officials will never see those documents.

It is a question of how are you going to encourage companies to have this self-policing function and at the same time to encourage employees to be honest and forthright with their internal auditors.

Senator QUAYLE. Would you say they ought to have a suspicion of fraud or something of that caliber before they would have access to the internal audits? Or would it be your position just to prohibit access to all from auditors? Obviously, the Federal prosecutors could have access to that if they were conducting criminal prosecutions.

What I am trying to establish is what areas of information or work products do you think ought to be excluded from automatic access from Government auditors?

Mr. SAUBER. Focusing on this particular issue, I think that auditors, defense contract auditors, ought not to have automatic access to the internal audit reports, which I think is the issue on which there is some controversy today. If there is an allegation or a suspicion of fraud, the criminal investigators can subpoena those documents anyway and do and get them.

So, once you raise the level that there is enough basis for a serious criminal investigation, that information is available to the Government as it is. I think it is the automatic disclosure that the Defense Contract Audit Agency is looking for now that will tend to water down that function, which may in fact not be related to the mission that DCAA is supposed to perform.

Senator QUAYLE. Are there other work products that you think ought to have that same kind of standard?

Mr. SAUBER. I think there is a whole range of management data and financial data that is sort of basic to running any sort of commercial enterprise, that I think in the association's judgment ought

not to be automatically and routinely disclosed to Government auditors unless you can show that they are clearly and directly related to the job the auditors are trying to do. And I think that is the association's position.

Senator QUAYLE. Do you have a list of those work products you would like to see exempt?

Mr. SAUBER. I have none with me. I think that the association would be happy to put together a list and submit it.

Senator QUAYLE. I would be interested in seeing a list of the work products of business that they think should not be granted automatic access.

Mr. SAUBER. We would be happy to.

[See letter dated April 19, 1985, from American Electronics Association, Appendix A, p. 77.]

Senator QUAYLE. Maybe, Mr. Singleton, you could also furnish that as well.

Mr. SINGLETON. Yes, sir; we will.

Senator QUAYLE. Distinct lines should be drawn between audit and investigation functions. Do you want to expand on that? I mean, you just heard Mr. Helm and Mr. Sherick say that there were distinct lines and they were not bumping into each other. You obviously do not agree with that. Do you want to tell me how we could better draw the lines of jurisdiction?

Mr. SAUBER. Well, if I may first, I was referring to a couple of different things, which I will be happy to explain. I was a little uncertain about what Mr. Sherick was saying, to say that this group of 10 people that comes into the plant are not really auditors, they are factfinders. If they ask——

Senator QUAYLE. They are investigators.

Mr. SAUBER. If they ask for 10 files and ask for all the files on 180 contracts, I do not really think that it matters to the company whether they are called auditors or investigators or representatives of the Department of Defense or whatever they are called.

It is still going to cost them money, the company, in time and funds to respond to those kinds of requests. And if you are responding over and over again to the same kinds of requests, at some point you have to ask yourself, well, this information exists in the Government somewhere, and rather than come back and ask us for it over and over again, why can there not be some sort of realization that this information exists somewhere in the Government and somebody can have access to it?

The other, the more specific item that the association addressed in its submission, refers really to the blurring of the lines between the inspector general's investigators and incumbent upon companies that if there is a criminal investigation—and that is what the IG does, his investigators.

I mean, the name of the organization is the Defense Criminal Investigative Service, and one has to assume that they were so named for a reason and that is that they do criminal investigations. When they come in and start asking questions, I think it is incumbent on a company to advise its employees that this is a criminal investigation, with the attendant problems, and this is not a contract audit any longer.

And it is the uncertainty, I think, that some companies have. Are they dealing with auditors here, are they dealing with investigators? That leads you to assume, if you are a company, assume the worst, and you have to assume that you are dealing with criminal investigators.

I think that leads to roadblocks in the relationship between the company and the auditors and difficulty in getting access to data and employees.

Senator QUAYLE. So, how would we redraw the lines of jurisdiction?

Mr. SAUBER. I am not certain that the IG should have authority to do contract audits. Presently, he does not, but I think you heard him say that he has several hundred auditors and that they are at contractor facilities doing something.

And I think that the DCAA people that I have worked with over the years are exceptionally competent and well motivated to do that kind of work. I think a clear sense from this committee to the IG that his investigative responsibility ought to be completely separate from the audit responsibility as a policy rule might go a long way toward keeping in people's minds that that is, in fact, the line of demarcation that ought to be observed.

Senator QUAYLE. Mr. Singleton, do you want to add to that?

Mr. SINGLETON. Well, currently, we have an inspector general audit team in plant. To tell you the truth, it was several months into the audit—they have been there for nearly 5 months now—several months into the audit before we realized that they were not doing an investigative audit. They explained to us that they were doing just a postaward audit; and that if it was truly an investigative audit, it would be a different team that was in reviewing us.

But as far as I can tell—and I deal with them on a daily basis—they are doing essentially the same audit tasks that DCAA would do, except to a quite larger extent, covering a larger number of contracts.

Senator QUAYLE. You are saying that the IG's auditors perform essentially the same task and functions of the DCAA auditors?

Mr. SINGLETON. Yes, sir.

Senator QUAYLE. From your experience.

Mr. SINGLETON. Yes, sir.

Senator QUAYLE. Mr. Sauber, do you have any case examples like that?

Mr. SAUBER. I have no case examples. I have seen both in and out of the Government the appearance of IG auditors at contractor facilities to gain access to contractor records, for reasons that as Mr. Singleton just indicated, seem unclear.

And as a criminal lawyer, I would advise people dealing with the IG to take different kinds of steps to protect their employees and to be sensitive to the rights of their employees than were they dealing with the defense contract Audit Agency.

Senator QUAYLE. Do either one of you want to respond to all of the testimony and discussion we had today on unallowable cost-reimbursement expenses that are submitted? Do you want to make any general comment? We did not really want to get into duplication, but since we got off on that issue on behalf of industry since

you are here, do you want to make any statements of fact or relevancy or irrelevancy concerning the testimony that we had today?

Mr. SAUBER. I would like to make some irrelvant comments, if that is one of the choices. [Laughter.]

Senator QUAYLE. You can make irrelevant and maybe even irreverent. [Laughter.]

Mr. SAUBER. I would like, as a former prosecutor and a criminal lawyer, to talk about that certification, that perjury certification for a moment if I could. My dealing with the Federal criminal law was that it was an enormously flexible tool, and I can think of two or three or four different Federal criminal statutes that would cover the intentional and willful submission of a false bill or false statement to the U.S. Government.

So, the idea that we need yet another requirement for certification seems to me to be maybe superfluous and it may be missing the point. Especially, I think the wording—and I have not seen it; I simply heard it read—to say that anyone who submits something that is unallowable is going to be subject to some kind of criminal penalty seems to be a little difficult to enforce, since unallowability is obviously a grey and difficult arena that is subject to all sorts of different interpretations, and allowability may be determined only after years of litigation.

And I do not really see the Justice Department prosecuting something on the ground that somebody submitted something that was unallowable. I think what you will see as a result of this kind of certification is an enormous amount of time spent by contractors and outside lawyers reviewing the overhead submission and advising the executive, who does not have the time to sit down and review thousands of accounting entries, about whether or not this is allowable and that is allowable, and these are the different kinds of interpretations.

And my understanding of what is allowable overhead is that all of those costs will now also be allowable. So, we may, in fact, with that kind of certification be increasing the overhead costs, rather than addressing an issue that is of obvious concern.

I think we can agree that what we want to get at is companies who throw in clearly and obviously unallowable kinds of costs and say, we will let the auditors find it if they can. That is not the kind of operation I think that we want to encourage, and I think that is the real nub of the issue.

I think this arena could also use a little bit more definiteness in the definition of what is allowable and what is unallowable. But to add another layer of the certification that may, in fact, where we do think it out a few days in advance, might increase cost, does not seem to me to be the most effective way to approach it.

Senator QUAYLE. I tend to agree that what we are trying to get at is those things that are clearly unallowable, where people—and they said it today—basically go ahead and claim all their expenses as allowable and hope that when they negotiate the bottom line with DCAA, that we will miss a few things that we would normally say are unallowable and they will come out ahead.

And some of those things are clearly unallowable. They know it. The problem is, what kind of incentives should we put into this system to prohibit that to begin with? I do not know if there are

any incentives right now. I mean, they just sort of negotiate this thing out, and if they find it that is fine.

And maybe the adverse publicity is an incentive, but I do not like that. I think that is injurious to the whole concept of national defense and national security and things of that sort. There may be an incentive in the system, but it is not terribly helpful.

What kind—I think what Weinberger is looking at, well, maybe we will shift this thing from civil remedies to potentially criminal remedies. That is what he has done in that certification process. He has elevated it from civil retribution to the criminal process.

Mr. SAUBER. Well, I think at first blush that may be what it looks like. I think, though, it puts in another level of review and cost that may not be the best way to approach it.

I do agree that there ought to be an incentive to withhold clearly unallowable kinds of costs. There is a tremendously wide gray area about what is allowable and what in unallowable, and more definiteness in identifying those kinds of costs might be helpful.

Senator QUAYLE. Can we do that legislatively or would you do it through interpretations of regulations, or both ?

Mr. SAUBER. My own view is that I think there is a proposal in the—currently working its way through the system in the Federal acquisition regulations, to make a little bit more definite some of these definitions. It seems to me, though, to be a level of detail that is better left to the regulatory process rather than the legislative process, and my knowledge of this proposed new regulation is that that is in fact what it addresses.

Senator QUAYLE. What kind of incentives do you think we could put in the system that would certainly serve as a strong deterrence to companies not to do this, to submit unallowable claims?

Mr. SINGLETON. Well, I would say that severe penalites ought to be imposed on those companies that against regulation submit overhead claims that include clearly unallowable costs.

Senator QUAYLE. Treble damages?

Mr. SINGLETON. I am not prepared to say what damages should be, but perhaps, depending upon the extent of the violation, damages might be paid.

Senator QUAYLE. Would debarment be a possibility?

Mr. SINGLETON. I believe that system probably allows for such a thing right now. The submittal of clearly unallowable overhead claims, with cost accounting standards which are, as far as we are concerned law, and I believe a neglect of following those standards, that ultimately would be debarment.

What I also believe—and this applies to a fixed price environment—is that once a contract is negotiated using previously established overhead rates and then the contractor is self-motivated to reduce costs to something lower than even negotiated, I think there is an incentive right there. To increase profit by reducing costs is an incentive.

And also, in a fixed price environment it has been my experience that oftentimes follow-on procurements are based on the intital cost contract. So, the Government would be able to take advantage of this situation. If the constractor underran an initial contract, that would become the basis for still lower costs on the follow-on procurements.

And so I think there is a built-in incentive to the contractor, if he does not run the risk of defective pricing allegations when he tries to motivate from within his company, to reduce overhead costs, or direct costs, for that matter.

Senator QUAYLE. OK, gentlemen. Thank you very much.

[Questions with answers supplied follow:]

QUESTIONS SUBMITTED BY SENATOR DAN QUAYLE

BACKLOG OF OVERHEAD COST AUDITS

Senator QUAYLE. Mr. Helm, it is my understanding that overhead accounts for most major defense contracts have not been fully resolved for a number of years. Why is there such a backlog in closing out contracts?

Mr. HELM. There are some major contractors for which the overheads have not been finalized for several years. This is usually due to significant legal or cost issues that require adjudication either by the ASBCA or the courts or other significant issues in dispute.

Senator QUAYLE. Also, once overhead accounts are resolved, who generally ends up owing money—the Government or the contractor?

Mr. HELM. On flexibility-priced contracts, the Federal Acquisition Regulation requires the establishment of billing rates as close as possible to the final indirect cost rate anticipated for the contractor's fiscal period, as adjusted for any unallowable costs. Although theoretically this procedure is designed to result in neither the Government nor the contractor owing money, the practicality of the situation is that there are generally some differences each way. DCAA is currently reviewing the billing rates at all major contractor locations to assure that we are holding back enough money to cover all of the unallowable costs when the overheads are finalized.

AUDIT RESOURCES

Senator QUAYLE. Mr. Helm, do you have the resources necessary to perform your responsibilities?

Mr. HELM. Yes.

OVERLAP WITH DCAA

Senator QUAYLE. Mr. Helm, do you believe that there is any overlap between the responsibilities of the DCAA and those of the Inspector General?

Mr. HELM. No. DCAA is responsible for providing audit support to the procurement community relative to the award and administration of contracts. The IG is responsible for the oversight of the Department's programs and operations. At times there may appear to be an overlap such as the current activity relative to defective pricing. This project is the result of the IG's review of spare parts and is being performed consistent with prior coordination between DCAA and the IG. DCAA is performing the audits for the IG at all locations where DCAA has a resident staff. The IG is performing the audits at the other contractor locations. Therefore, there should be no overlap. In a rare instance there can occur a simultaneous visit to a contractor by both a DCAA auditor and an IG auditor. However, each would be performing a different function.

ALLOWABILITY OF PUBLIC RELATIONS EXPENSES

Senator QUAYLE. Mr. Helm, a proposed amendment to the FAR has been issued regarding allowable public relations expenses. The proposed regulation would permit reimbursement of costs of participation in community service activities and of open houses.

Why is this a sound regulation, and does it not create a number of grey areas and possible inconsistencies with rules on donations or entertainment?

Mr. HELM. The intent of the proposed regulation is to eliminate to the maximum extent possible grey areas and inconsistencies as well as to redefine our policies. The proposed regulation has been published for public comment. Promulgation will occur only after the public comments have been analyzed and needed clarifications or other revisions have been made. This is not a static environment in which we operate and we are affected by adjudications of both the courts and the ASBCA. Fortunately, our procedures allow us the opportunity to make the necessary modifi-

cations to our policies consistent with the dynamics of the arena in which we must function.

REVOLVING DOOR

Senator QUAYLE. Mr. Helm, what would be your view of a restriction on DCAA personnel at a contractor plant from going to work for that contractor for a period of time after leaving the Government?

Mr. HELM. DCAA personnel are currently subject to the Ethics in Government Act (18 USC 207) which permanently bars them from participating in any action that they were involved in while working for DCAA. It should also be noted that the DCAA auditor does not award contracts and only provides financial advice to the contracting officer who is the awarding official. Additionally, in 1984 a total of only 64 DCAA auditors reported that they were going to work in private industry. This generic category includes public accounting firms, nondefense contractors, other private employment as well as defense contractors. It is also significant to note that over 50 percent of the losses to private industry were individuals at the journeyman level and below.

Senator QUAYLE. Mr. Helm, could you describe your training program for auditors?

Mr. HELM. During their first year with the Agency, DCAA auditors attend formal technical training courses at the Defense Contract Audit Institute in Memphis, Tennessee and also receive extensive on the job training. The institute offers more than 20 courses covering such topics as pension costs, advanced audit techniques, information systems and data retrieval and interviewing for recruitment and selection. The Agency also has a management development program. The first objective is to raise the level of management effectiveness by improving incumbent's performance in their present positions. The long-range objective is to prepare those with recognized potential for future advancement and responsibility.

COST ACCOUNTING STANDARD BOARD

Senator QUAYLE. Mr. Helm, do you believe we need a new mechanism to adjust the cost accounting standards, and, if so, what should that be?

Mr. HELM. I believe the new Cost Accounting Standards Policy Group will satisfy our needs. This group will perform functions previously accomplished by the CAS Board, including a control point for CAS waivers and the updating of the standards. As we previously stated at other hearings, we believe that the DOD can handle the CAS program under the Federal Acquisition Regulation.

WARRANTIES

Senator QUAYLE. Mr. Helm, is DCAA auditing warranty costs in proposals? Have you developed a mechanism for doing this?

Mr. HELM. The Defense Procurement Reform Act requires DOD to obtain certain types of warranties in contracts awarded after January 1, 1985 for the acquisition of weapon systems. Our procurement regulations (Subpart 46.7 of DFAR) requires each weapon system contract contain three specific warranties, one covering design and manufacturing requirements, one covering defects in materials and workmanship and one covering essential performance requirements delineated in the contract. As provided for in the law, the Secretary of Defense may waive part or all of the requirement if the waiver is necessary in the interest of national defense or if the guarantee would not be cost effective.

It is the policy of the DOD to only obtain warranties that are cost effective. In order to determine this, an analysis must be performed to compare benefits to be derived with its acquisition and administration costs. Since the acquisition costs are part of the contractors price proposal, DCAA would review such costs as part of their review of the proposal. As a practical matter, there are difficulties in performing this review because of the lack of discrete historical data or experience.

ACCESS TO INFORMATION

Senator QUAYLE. Mr. Helm, do you believe you have adequate access to contractor information to perform your job?

Mr. HELM. The vast majority of defense contractors provide appropriate access most of the time. Occasionally access to particular documents may be delayed or denied and DOD is forced to take extraordinary action to obtain access. Depending on the circumstances, this can consist of refusing to award a contract, withholding payment, issuing a subpoena, or obtaining an order from a judge to produce the doc-

ument. All of these actions have been, and are being taken, when considered appropriate.

DOD obtains its right of access under contract terms or by statute. P.L. 87-653 provides access necessary to assure compliance with the Truth in Negotiations Act. The Cost Accounting Standards clause provides for access to assure compliance with CAS. Various other contract clauses provide access necessary for the purpose covered by that clause (e.g. progress payments). Reasonable people can always disagree on what specifically is covered by a given clause. Such disagreements are usually resolved rather quickly using regular administrative procedures. It is when administrative resolution fails that DOD must avail itself of some of the remedies cited earlier.

BOTTOM LINE NEGOTIATIONS ON OVERHEAD EXPENSES

Senator QUAYLE. Mr. Helm, it is my understanding that once DCAA questions certain overhead expenses, the administrative contracting officer does not try to determine allowability of each questioned expense, but rather enters into a bottom line negotiation where the contractor is given a portion of the challenged expenses.

Assuming that most of DCAA-questioned expenses are correct, does this not mean that by design we are permitting contractors to be paid for items that are unallowable?

Mr. HELM. The reason we have the negotiation process is because not all overhead allowability determinations are self-evident. This is further evidenced by the need for the ASBCA which responds to contractor appeals to contracting officer determines. Although the contracting officer does try to determine the allowability of each questioned expense there are these grey areas for which each side has valid arguments. It is for these grey areas that a contracting officer may resort to bottom line negotiations as the means for both sides to resolve the larger overhead finalization requirement.

EXECUTIVE COMPENSATION

Senator QUAYLE. Mr. Helm, it is my understanding that executive compensation is allowable if the total compensation conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services or work performed. FAR 31.205-6. Arch Patton, who is probably the most knowledgeable person in the country on executive compensation, had an article in the March 3 Washington Post in which he discussed the tendency of corporations to overpay underachieving bosses. He generally described the huge escalation of executive compensation.

For example, if we take two large defense contractors, the chairman of General Electric has total compensation of $2.8 million and the chairman of TRW has total compensation of $2.7 million. This makes these two executives worth about as much as the entire United States Senate.

Should taxpayers really underwrite this kind of compensation?

Mr. HELM. This question extends beyond defense procurement and applies to our entire free enterprise system. Although compensation is an area that we in the DOD have been amplifying our efforts in recent years, it is a very complex subject. For example, historically, the commercial/Government sales ratio at General Electric has been approximately 80/20. Such a ratio would imply that the commercial activity, i.e., the commercial competitive marketplace, is controlling the rate of executive compensation.

SUBPOENA POWER

Senator QUAYLE. Mr. Helm, does DCAA need subpoena power?

Mr. HELM. Overall, we do not believe that access problems are so pervasive or critical that any particular corrective action is necessary. However, we are considering requesting the subpoena authority for DCAA. DCAA now makes use of the DOD IG's subpoena authority in those rare cases where this extreme action must be taken as a last resort. A current test of this arrangement is being made. The DOD IG issued a subpoena to Westinghouse Corp. to obtain access to its internal audit reports and review schedules. This test demonstrates the substantial delays that can be experienced under this arrangement. Since there may be situations where time constraints would not permit extensive delays, granting the subpoena authority to DCAA might be the more efficient approach.

CHARTER

Senator QUAYLE. Your charter is exceedingly broad. Do you think the charter should be more specifically focused?

Mr. SHERICK. My charter is broad. It is based on the Inspector General Act of 1978, as amended, which deliberately grants broad authority to the Inspectors General so as not to unduly restrict their activities in fulfilling their assigned mission. It is this breadth of authority which permits an Inspector General to function in compliance with the law and the intent of Congress when it passed the law. Any change to the charter to more specifically focus its application could be counterproductive and potentially serve to hinder the efficient and effective implementation of the congressional mandate.

ACTIVITES

Senator QUAYLE. Who establishes the priority of your activities?

Mr. SHERICK. Ultimately, as Inspector General, I am responsible for establishing the priorities of my office. It is my policy that we will examine and consider all requests for audits, inspections or investigations. These requests come from many sources, including the Secretary, or Deputy, of Defense, other Executive Branch officials, members of Congress and the general public. While we consider all matters referred to us, I must operate within the limitations of my resources. Also, there are often legitimate reasons for declining a case or referring it elsewhere in the Government.

My office prepares an annual consolidated operating plan, based on the input of virtually all major DOD elements. This plan reflects my priorities pertaining to IG operations and considers departmental coverage, audits, inspection requests, proactive activities, organizational structure, follow-up, and oversight and evaluation projects. My priorities and views are reflected in the IG plan, and great care is taken to ensure that our overall operating philosophy is consistent with the congressional mandate for the OIG, DOD, and the needs of the Department of Defense.

INVOLVEMENT WITH DOD CONTRACTORS

Senator QUAYLE. DOD Directive 7600.2 states that you shall perform audits of the entire procurement process. Could you describe the range of activities involving DOD contractors?

Mr. SHERICK. The origin of the referenced responsibility of the Assistant Inspector General for Auditing is the Congress. The Secretary of Defense was directed by the Congress to transfer 100 positions to the Inspector General to be filled by persons trained to perform contract audits. The Congress was clear in its intent that these auditors not be used to advise contracting officers in the process of negotiating contracts, a function that remains in the Defense Contract Audit Agency. Rather, the contract audit capability was to be used ". . . to provide the Inspector General flexibility and resources in situations where he deems it necessary or appropriate to look at entire procurements—the performance of defense contractors as well as the performance of defense personnel."

SETTING DOD POLICY

Senator QUAYLE. You are periodically asked about DOD policy on certain subjects, such as progress payments or revolving door. Is it the IG's role to set DOD policy in areas like these?

Mr. SHERICK. My specific policy making authority involves audits and criminal investigative matters. This is not to say, however, that the IG has no role in other policy matters. The Inspector General Act of 1978, as amended, specifically charges the IG with the review of existing and proposed legislation and regulations relating to the Department's programs and operations and to make recommendations concerning their impact on economy and efficiency, or on the prevention and detection of fraud and abuse, in DOD programs and operations.

We make recommendations for changes in Departmental policy based on experience gained from our audits, investigations, inspections, and the review of legislation and regulations. We take this responsibility very seriously and provide comments whenever we feel that our experience can improve the proposed policies, or changes to policies, of the function or program in question.

Senator QUAYLE. Mr. Sherick if you have no policy role in such areas, would it not be a sound practice to so indicate and to direct inquiries to the Secretary of Defense?

Mr. SHERICK. It is my duty to recommend policies concerning activities carried out or financed by the Department of Defense for the purpose of promoting economy and efficiency in program administration, and preventing and detecting fraud and abuse. Specific inquiries regarding DOD policy are referred to the offices within the Department responsible for formulating and implementing those policies.

INDEPENDENCE OF DCAA

Senator QUAYLE. Legislation introduced in the Senate last year would have placed DCAA under the control of the Inspector General. What is your view of such a proposal?

Mr. SHERICK. I have yet to be convinced that such an action would benefit the Department of Defense or result in improved audit effectiveness. Many operating problems would be created by absorbing an organization four times the current size of my office and an audit organization with vastly different responsibilities. As a consequence, I have not supported such a transfer. The DCAA needs improvements in several areas and I believe that DCAA is addressing these problems. If they are unable to satisfactorily resolve these problems, then I would consider supporting a proposal to transfer the post award audit activities of DCAA to the Inspector General.

SUBMISSION OF UNALLOWABLE OVERHEAD COSTS

Senator QUAYLE. Should the submission of certain overhead costs for reimbursement by the government when such costs are clearly unallowable be considered fraudulent?

Mr. SHERICK. A claim such as that could be considered fraudulent if the contractor knowingly and willfully files a claim he knows to be false or fraudulent.

AUDIT QUALITY

Senator QUAYLE. Some IG audit products, such as your report on Cost Growth of Aircraft Engine Spare Parts issued on February 10, 1984, have been wrong the first time. What are you doing to improve the quality of your audit work?

Mr. SHERICK. To maintain a high quality in our audit work and reports, a quality control program is and always has been in effect. After an audit is announced we conduct an audit survey which usually lasts about 4 weeks. After the survey is complete, our quality control program starts. The Program Director and the Project Manager outline the potential findings and decide to either proceed with the audit, change the scope of the audit, or in some cases, discontinue the review.

In the next step of our quality control program, experienced Program Directors and Project Managers carefully review the work performed and the working papers prepared to ensure the professional quality of the audit.

After the field work is complete, auditors meet with managers of the audited organization to discuss the findings. Then a quality team, consisting of the Program Director, the Project Manager, a desk officer knowledgeable in the audit area and an editor, meet to agree on the thrust of the findings. This team maintains a close working relationship during the report writing phase to assure a high quality draft report.

Before a report is issued, either in draft or final form, the data are traced to the original sources. The report is reviewed at several levels to ensure the factual content of the report, as well as the logic and reasonableness of the audit conclusions.

Desk officers review the draft report for technical accuracy and compliance with the auditing standards established by the Comptroller General of the United States. The desk officers ensure the report contains enough competent and relevant evidence to support the auditor in judgments and conclusions regarding the organization, program, activity or function audited.

Technical experts on our staff are available to serve as an internal "sounding borad" so that multiple viewpoints are heard and the quality of our reports is thereby enhanced. Our technical experts include engineers, business and industry analysts, a contract price analyst, a contract specialist, an operations research analyst, an industrial specialist and a logistics management specialist.

Editors ensure that the report is clealy written, concise and flows logically so that a reasonable person has no difficulty understanding it. When the technical and editorial reviews are complete, senior managers in the audit organization review the report before it is issued.

To prevent data from being released prematurely, the front covers of our reports state:

"This proposed audit report is being issued to management in order to obtain comments and a statement of corrective actions to be taken. The report may be revised as a result of comments received and further reviews by the Office of the Inspector General.

"Distribution of this report outside of the Department of Defense is not authorized. Safeguards must be taken to prevent publication or improper disclosure of the information contained in the report." In the case of the draft report in question, this caveat was ignored by someone.

Managers at the audited organization are given a chance to comment on draft reports, and their comments are considered in issuing the final report. Based on the management comments received, we make appropriate changes to the draft report, and in most cases, management comments are included as appendices to the final report.

As an additional quality control procedure, we perform peer reviews of selected audit projects. Periodically, a panel of Program Directors analyze completed projects to verify the accuracy of the reports and to determine if the auditing standards established by the Comptroller General of the United States have been met. We use this process to determine whether quality control problems exist so we can take the necessary corrective actions.

We make every effort to present a balanced analysis of our findings and to make a convincing case for corrective actions recommended. Our quality control procedures have paid off in better audits and reports. While we strive for perfection, we recognize that we do not always achieve it. Nonetheless, the incidence of the type of error mentioned in the question is very low. We believe that our extensive control policies and procedures are responsible for our high rate of accuracy.

AUDIT POLICY

Senator QUAYLE. DOD Directive 7600.2 states that you shall perform audits of the entire procurement process. Could you describe the range of your activities involving DOD contractors?

Mr. SHERICK. The range of Inspector General, DOD, audit activities involving DOD contractors is primarily associated with three new audit directorates established in 1983 within the Office of the Assistant Inspector General for Auditing. These directorates evaluate the cooperative efforts of the various DOD activities involved in procurement, contract administration, contract audit, accounting and finance. Reviews focus on areas such as acquisition requirements, source selection, price determination, contract payment, contractor performance and recovery of funds due the Government.

The Contract Audit Programs Directorate provides management with independent, objective and constructive evaluations of the economy, efficiency and effectiveness with which defense contracts are administered and performed, and makes recommendations for improvement. Reviews generally involve more than one DOD component. Audit criteria include provisions of the Federal Acquisition Regulation, Defense Acquisition Regulation and Public Law. While the Directorate's responsibilities cover the spectrum of procurement policy and practices, it is primarily concerned with issues that affect contract pricing and with policies and practices which can be evaluated through analysis of contract prices.

The Major Acquisition Programs Directorate performs "vertical" audits of major Defense programs. In a "vertical" audit, auditors examine all relevant phases and management levels of major acquisition programs, starting from the OSD level and continuing through the Military Departments to the major subordinate commands and contractors and subcontractors, as appropriate. Reports from this Directorate tend to focus on a specific weapon system.

The third directorate involved in the acquisition audit process is our Acquisition Support Programs Directorate. It focuses primarily on the missions and performance of the procuring contracting officer and the administrative contracting officer. This Directorate evaluates how well DOD management defines acquisition requirements, awards contracts to fulfill these requirements, and subsequently administers the contracts so that DOD will obtain required goods and services at fair and reasonable prices. Audit criteria include provisions of the Federal Acquistion Regulation, component implementing instructions and other DOD regulations. This office concentrates on "horizontal" issues which cross functional lines to identify how pervalent a problem is throughout the Department.

In summary, the three new acquisition directorates provide comprehensive coverage of the acquisition process and, each in its own way, contributes to our range of activities involving DOD contractors. The long-term objective of our acquisition

audit program is to perform contract and procurement audits which will continually improve the efficiency and effectiveness of the contracting process.

OVERLAP WITH DCAA

Senator QUAYLE. Do you believe that there is any overlap between the responsibilities of the DCAA and those of the Inspector General?

Mr. SHERICK. No. The audit roles of the DCAA and the Inspector General are very different. The DCAA audits the financial records of contractors to provide the contracting officer with information required for the award and administration of individual contracts. In contrast, the audit element of the Inspector General evaluates the actions of DOD management to ascertain the economy, efficiency and effectiveness of DOD systems, programs, and operations. The audits of the Inspector General result in recommendations to DOD management for changes in policies and procedures of the DOD components. Recommendations made by DCAA to the contracting officers relate the actions required on a specific contract proposal or contract.

ACCESS TO INFORMATION

Senator QUAYLE. Do you believe you have adequate access to contractor information to perform your job?

Mr. SHERICK. Yes. Contractors have usually provided requested data in a timely manner. However, to date, I have issued 28 subpoenas to obtain contractors' records. With one exception, all of the access issues covered by these subpoenas have been successfully resolved. The one exception is now before the Federal courts for enforcement.

Senator QUAYLE. Mr. Singleton and Mr. Sauber, could you identify specific instances of duplicated auditing that you may be aware of, and explain, to the best of your ability, why it appears that the duplication existed?

[For answer, see Appendix, letter from American Electronics Association.]

Senator QUAYLE. Mr. Singleton, you state in your testimony that "control of contractor overhead costs should be the sole responsibility of the contractor." You go on to suggest that such control by DOD will make defense contractor "quasi state companies managed by the Department of Defense."

Does not the Department of Defense have a legitimate interest in a cost type contract in specifying what types of costs it is willing to pay a contractor?

[For answer, see Appendix, letter from American Electronics Association.]

Senator QUAYLE. Mr. Singleton and Mr. Sauber, what effect would giving DCAA subpoena power have on the DCAA-industry relationship?

[For answer, see Appendix, letter from American Electronics Association.]

Senator QUAYLE. Mr. Sauber, what should the Government do differently in an audit context once it suspects criminal activity in terms of ensuring the rights of the company being investigated?

Mr. SAUBER.

[For answer, see Appendix, letter from American Electronics Association.]

Senator QUAYLE. Mr. Singleton and Mr. Sauber, would it be fair to impose a penalty on companies that submit overhead costs for reimbursement that are clearly unallowable?

[For answer, see Appendix, letter from American Electronics Association.]

QUESTIONS SUBMITTED BY SENATOR JOHN WARNER

PRINCIPLES OF OVERHEAD

Senator WARNER. Secretary Weinberger indicated in his military posture statement on 4 February that DOD had initiated a joint service review to look at ways in which we can reduce defense contractor overhead costs. Some of the areas they will be addressing are the principles of overhead cost control and development of incentives with industry to reduce overhead costs.

Could you elaborate more on this review and some of the results to date?

IMPROPER BILLINGS

Mr. SHERICK. Under the principles issued by the Deputy Secretary the Military Services and the Defense Agencies were tasked to review their own contract requirements, particularly those which cause contractors to incur indirect costs. Determinations are to be made as to whether the requirements are cost effective and they are to be eliminated when they are not. Additionally, our acquisition communi-

ty was directed to assure that current procedures are being followed in the review and evaluation of estimated indirect costs that are used for pricing negotiated contracts. As a new procedure, each of the Services and DLA were directed to test a should cost review of at least one contractor location. The reviews were to be completed by September 30, 1985. Finally, DCAA has been directed to reexamine the basis used for allocation of indirect costs. DCAA is to determine whether traditional methods of allocating these costs have been overcome by technological changes. If so, DCAA will recommend new procedures. Thirty contractor locations have been selected for the initial review.

Senator WARNER. Last week, DOD announced it was suspending progress payments to a major defense contractor because of improper billings to the Government. This action is only a temporary remedy to the overall problem.

What action is DOD taking to ensure defense contractors are not reimbursed for improper cost charges under defense contracts?

LOOPHOLES IN REGULATIONS

Mr. SHERICK. The Secretary of Defense directed that DCAA review the billing rates being used by every major contractor to determine that they have been set low enough to assure that no unallowable costs will be paid to the contractors even on a interim basis.

Senator WARNER. Are there "loopholes" in our current regulations? Or is it a case of discipline?

Mr. SHERICK. Yes. There are loopholes in the current regulations. We have a number of revisions in process to eliminate this problem.

TOO MANY AUDITS

Senator WARNER. We often hear acquisition managers criticize that there are too many audits which adversely affect their ability to effectively manage their programs. What actions are being taken to improve audit coordination to minimize the impact on PM?

Mr. SHERICK. I placed a very high priority upon the coordination and planning of audits to assure the most efficient and effective use of available audit resources. To date, I have published three policy documents dealing with audit coordination. Also, my staff has conducted two oversight reviews to assure compliance with this policy guidance. The three policy documents on audit coordination include: DOD Directive 7600.2, "Audit Policies," dated January 10, 1985; Contract Audit Policy Memorandum Number 1, "Relationships Between Contract and Internal Audit Organizations," dated December 21, 1983; and DOD Internal Audit Manual. This policy guidance requires DOD audit organizations to:

1. Consider the work of other audit and oversight organizations in the development of annual audit plans.
2. Exchange copies of annual audit plans with other DOD audit and inspection organizations and General Accounting Office.
3. Exchange copies of audit announcement memoranda with other DOD audit organizations.
4. Participate in the planning and performance of joint DOD-wide audit projects.
5. Periodically meet with General Accounting Office representatives to discuss audit plans.
6. Review prior audits and studies in connection with planning of work on current audit projects.
7. Coordinate all reviews involving contractor records with Defense Contract Audit Agency and appropriate contract administration offices to avoid duplication of audit work.

In addition to the above, the chiefs of the major DOD audit organizations meet periodically to discuss audit matters of mutual concern. Also, I have established a DOD Internal Audit Policy Group to advise me on DOD-wide audit policy matters, including audit planning and coordination.

Oversight reviews conducted to date by my office have not disclosed any significant problems as to duplicative or excessive audit coverage of DOD acquisition programs. On the contrary, I believe that more coverage is needed in view of the significant dollars being committed to major acquisition programs.

QUALITY OF COST ESTIMATES

Senator WARNER. Typically, DOD cost estimating methodology has relied heavily on the use of historical cost data. This practice sometimes results in poor cost esti-

mates because of differences or uniqueness in state of the art technology or manufacturing processes of a weapons system.

Could you explain what areas or other methods you are looking at to improve the quality of our cost estimates for weapons systems?

Mr. SHERICK. We are expanding the use of should cost reviews in evaluating the contractors' cost estimates. Should cost is an in-depth review conducted at the contractor's plant by a team of government experts in fields such as auditing, price analysis, engineering, manufacturing, procurement, etc., in order to determine what an item should cost.

Senator QUAYLE. The subcommittee will stand in adjournment.

[Whereupon, at 4:48 p.m., the subcommittee was adjourned.]

APPENDIX A

DEPARTMENT OF DEFENSE
INSPECTOR GENERAL
WASHINGTON, D.C. 20301

Honorable Dan Quayle
Chairman, Subcommittee on
Defense Acquisition Policy
Committee on Armed Services
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

During your Subcommittee hearings on March 12, 1985, we touched on the question of spare parts pricing. I mentioned that we completed a major Defense-wide audit of spare parts pricing in May 1984. Copies of the final report are enclosed for use by your Committee members.

The audit report identifies the major reasons why Defense activities paid unreasonably high prices for spare parts. One of the reasons was the cost allocation process whereby Defense procurement officials and the contractor agreed on a total price for all of the items on the contract but did not agree on the price of the individual parts. This is referred to as "bottom line" pricing. In these cases, a pricing formula or arbitrary distribution was used to assign the total price to the individual parts. This procedure resulted in some item prices that were disproportionate to the actual value of the items. In our audit, when we found an item price that was excessive, we determined if it resulted from a "bottom line" pricing technique. If so, we determined whether the total contract price was reasonable. We found contracts where the item price was excessive but the total contract price was reasonable and cases where both the item price and contract prices were unreasonable. Even when the price was reasonable for the contract, "bottom line" pricing has an adverse impact because the incorrect contract item price is used as the basis for billing the military customer and because this price is established in contract history files and used as the baseline for future procurements.

The Subcommittee asked whether or not our spare parts audit reviewed contractor overhead costs. We did not specifically look at individual contractor's overhead costs. The objective of our spare parts audit was to determine if the procuring activity paid more than the intrinsic value of the item. In making our determination we used engineering estimates of the item's worth, the cost of similar commercial items, prices available from other vendors as well as actual costs of the contractor from which the item was procured. Even when a contractor's recorded costs, including overhead, indicated that the cost incurred was equal to the price paid, we categorized the item as unreasonably priced if we had indications that the price paid exceeded the item's value.

I share your concern regarding high overhead costs and have begun to focus some audit attention on this issue. In the spare parts pricing audit, however, we were able to gauge the reasonableness of the prices without assessing the overhead costs. The enclosed report should be of interest to those Committee members who had questions on "bottom line" pricing. If I can be of further assistance, please let me know.

Sincerely,

Joesph H. Sherick
Inspector General

Enclosures

American Electronics Association
Government Operations Office

AEA

1612 K Street N.W.
Washington, D.C. 20006

(202) 331-8050

April 19, 1985

The Honorable Dan Quayle, Chairman
Subcommittee on Defense Acquisition Policy
Senate Armed Services Committee
222 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Quayle:

AEA submits the following comments in response to questions raised by you in the hearing transcripts of the March 12 audits hearings. We would like to request that these comments be made part of the hearing record.

I. "Identify specific instances of duplicated auditing...and explain...why it appears..."

Government auditing may be duplicated in several ways. First, more than one agency may conduct the same type of audit. For example, DCAA and the DOD Inspector General both conduct post award audits. Another example is the duplication of efforts by the Defense Logistics Agency and the DOD Inspector General in reviewing contractor compensation practices. Second, it is not uncommon for several agencies to audit the very same information. During the proposal audit phase, for instance, DCAA, Defense Logistics Agency and the procuring agency audit the very same information. Third, it is a common practice for DOD audit organizations to reassign auditors prior to completion of assignments with the result that a new assigned auditor must start from the beginning. And fourth, it is not unusual for a letter contract to require multiple updates of cost proposal submittals, all of which are subjected to audit, before ultimate definitization of the contract.

Duplication in auditing can occur for several reasons.

1. Recent Congressional criticism of DOD audit practices has resulted in Government overreaction and misdirection of its audit resources.

2. There is often a lack of coordination between and within Government agencies which results in redundant audits.

3. Limited audit resources are assigned too many priority audits to effectively complete the "really important" audits in a timely

manner. Also, constant reassignment or replacement of auditors necessitates re-audit of the same information.

The Appendix of AEA's March 12 testimony before the Defense Acquisition Policy Subcommittee (enclosed) lists several examples of these audit problems.

II. "Does not the Department of Defense have a legitimate interest in a cost type contract in specifying what types of costs it is willing to pay a contractor?"

The Department of Defense does have a legitimate interest in specifying allowable and unallowable costs for both cost type and fixed price contracts. Our statement was made with reference to the Taft initiatives, whereby Government representatives would attempt to be active participants in planning and controlling contractor overhead costs. The implication is clear in the following excerpt from Secretary Taft's "Principles of Overhead Cost Control."

> Discrete Cost Analysis: Overhead costs must be evaluated on an element-by-element basis that concentrates on where contractor management decisions are made. Pricing methods which place undue emphasis on historical costs must be avoided. Evaluation tools such as Should Cost, Cost Monitoring Reviews, operation audits, etc., should be used to their fullest extent.

We maintain that the Department of Defense should expressly identify, in its regulations, the types of costs it considers unallowable for allocation to its contracts. Beyond identification of unallowable costs, the Department of Defense should limit its overhead cost control to tests of overall reasonableness and allocability. It is our opinion that the Department of Defense is not adequately staffed in numbers of qualified personnel to participate, in a meaningful sense, in the overhead control of its contractors.

III. "What effect would giving DCAA subpoena power have on the DCAA-industry relationship?"

The defense procurement environment is rapidly shifting from a buyer versus seller relationship to a prosecution versus defense relationship. Subpoena power would establish DCAA as investigators, not auditors. Matters relating to DCAA access to information, which are generally resolveable through procurement regulations, would be transferred to the courts.

In response to the Chairman's request for specific kinds of data to which auditors should not be granted automatic access, the following list is provided:

1. Internal audit reports;
2. Internal audit working papers;
3. Federal income tax returns;
4. Federal income tax return preparation working papers;
5. Legal staff reports;
6. Legal staff working papers, memos, files, etc.;
7. Corporate staff reports, memos, working papers, etc. not directly related to the recording of costs to be allocated to Government contracts;
8. Interviews with employees;
9. Employee personnel records; i.e. performance evaluations;
10. Strategic marketing plan;
11. Corporate or division profit plans;
12. Management letters from outside C.P.A. firms;
13. Correspondence from outside counsel.

AEA appreciates having had the opportunity to testify before your Committee and to respond to questions for the hearing record. We are happy to provide any further information you may wish regarding these or any other matters of interest to you.

Sincerely,

Kenneth C.O. Hagerty
Vice President, Government Operations

To give DCAA subpoena power would only serve to reinforce this trend and further demotivate potential entrants into the defense industry. It also would discourage existing contractors, especially those with mixed commercial/defense operations, from further government procurement activity.

IV. "Would it be fair to impose a penalty on companies that submit overhead costs for reimbursement that are clearly unallowable?"

It would be fair to impose a penalty on companies that submit unallowable overhead costs for reimbursement. However, such penalties should be imposed only on final contractor claims which are applied to flexibly priced contracts at the time of final settlement. It should be noted that progress billings and cost vouchers are normally prepared using interim overhead billing rates established by agreement with DCAA or the contracting officer. These billing rates are projections representing allowable overhead costs subject to change upon determination or agreement on final overhead rates. As such, interim billing rates are not actual expenditures and the contractor should not be subjected to penalty based on these rates.

It is fair to expect the contractor to exclude, from final rate claims, any overhead costs which are expressly unallowable by regulation. And it is fair to impose a penalty on the contractor who knowingly submits final rate claims which include unallowable costs. Penalties would serve to motivate the contractor to exclude unallowable costs, and remove much of the burden from government auditors to find the unallowables in the claim.

The penalty should not be a criminal or civil penalty imposed through costly litigation. It is our recommendation that the penalty for unallowable overhead cost claims take the form of a punitive reduction in allowable costs beyond the unallowable cost question.

V. "What areas of information or work products do you think ought to be excluded from automatic access from Government auditors?"

This question, asked during the hearing, was partially answered by Mr. Sauber, who stated that "if there is an allegation or a suspicion of fraud, the criminal investigators can subpoena" internal corporate information which should not be automatically available to auditors.

Internal management and financial data is essential in managing an efficient and competitive enterprise. Granting auditors automatic access to such information will diminish the effectiveness of important internal corporate investigative activities. Such an outcome would not be in the interest of either the contractor or the Government.

Comments submitted for the record by the Electronic Industries Association in response to questions raised in the hearing of March 12, 1985.

DUPLICATIVE AND EXCESSIVE AUDITS

Example 1: Corporate Insurance and Pension Costs

Each year beginning with 1977, and continuing to the present, the DCAS and the DCAA have performed separate, sequential and duplicative audits of insurance costs and of pension costs. These duplicative audits have resulted in the issuance of one or more duplicative reports by the agencies involved for each of the years in question. The burden from the duplicative effort has been substantial and invariably each of the agencies requires a copy of every document provided to the other.

Example 2: Compensation Reviews

In the period from November, 1981 to the present, separate and duplicative reviews have been performed by DCAS in the 1981-1982 period, again by the DCAS and DCAA during 1983, by GAO during the 1983-84 period and by Coopers & Lybrand on the behalf of the Air Force Contract Management Division during the period from November, 1983 to the present.

Example 3: Product Assurance

Duplicative reviews of scrap, rework and repair costs monitoring were performed by the AFPRO in the period April, 1983 to June, 1983 by the DCAA during the period January 1984 to October, 1984 and again by the AFPRO during August and September, 1984.

Example 4: Property Accounting

In the property accounting areas duplicative reviews and audits take place regularly in the following areas:

- Financial plans, budget estimates and five-year forecasts prepared are audited by the AFPRO and then audited again by DCAA.
- Each year the ADPE study is audited by DCAA and again by the AFPRO and the AFCMD.
- Lease expenditures are audited regularly by DCAA in connection with overhead negotiations. Last year a task force from AFCMD audited the identical expenditures.
- Contractor Management System Evaluation Program (CMSEP) reviews are regularly performed by the AFPRO. At the end of this year an AFCMD Contractor Operation Review (COR) will audit all functional areas previously audited.
- During the period August-September, 1982, the Air Force Audit Agency conducted a review covering virtually the identical areas covered by AFPRO CMSEP surveys on Government property.

Example 5: Progress Payments

The AFPRO and the DCAA routinely audit, separately and duplicatively, all progress payments.

Example 6: Price Proposals

From time to time both the AFPRO and the DCAA have performed duplicative reviews of the same cost elements in proposals. In addition, the Procurement Office and "should cost" teams will be reviewing the same cost elements.

Example 7: Spare Parts

Unpriced orders recently negotiated under a BOA were audited separately and duplicatively by the AFPRO, DCAA, and a separate spares acquisition support team. After the audit report was submitted to WRALC, its Price Analyst conducted a fact finding session on the same items. Also, we have learned that the same items are being reviewed by the Competition Advocate Group at WRALC.

Example 8: Duplication

In connection with a recent proposal, NAVAIR established a special audit team which in fact duplicated the normal audit functions being carried out by the local NAVPRO and DCAA. The three organizations have been repetitvely raising identical questions.

Example 9: Spares

In the spares area, widespread Government audit duplication has taken place. For example, the Navy "Price Fighter" team has been conducting an on-site review of price of items previously audited and negotiated. In addition, the Navy has established locally a "BOSS" (Buy Our Spares Smart) team of 8 to 10 people whose activities duplicate those regularly performed by the NAVPRO, the DCAA and the Aviation Supply Office.

Example 10: Material

The Material operation has been the subject of numerous duplicative audits. The Procurement System is under the continuous surveillance of the AFPRO. In addition to this surveillance, since October, 1983, the DCAA has been performing an operational audit of subcontract management duplicating the reviews performed by the AFPRO. In the period 29 July to 9 August, 1985, the Navy Contractor Procurement System Review (CPSR) team augmented by local personnel from the AFPRO will perform a detailed review of the purchasing system as occurs approximately every 4 years. In the period 9 September to 20 September 1985, the Air Force will be performing a Contractor Operation Review (COR), one purpose of which will be to evaluate the effectiveness of the Procurement System.

Example 11: Property

The AFPRO conducts Contractor Management System Evaluation Program (CMSEP) audits on a regular and continuous basis. Headquarters AFCMD has scheduled a COR Team visit in the period 9 September through 20 September 1985. All indications to date are to the effect that the COR Audit Team is going to cover the same functional areas that the AFPRO covers independently.

Example 12: Health Care Costs

AFCMD engaged Coopers & Lybrand to conduct an in-depth analyses of group medical plans of selected AFCMD contractors. The major objectives being:

- To compare health care programs of comparable defense and non-defense companies.
- To identify factors impacting health care costs.
- To develop alternatives to current practice which could constrain health care costs
- To describe the anticipated impact of the costs of these alternative approaches.

Currently the DCAA is conducting an operational audit of health care cost management consisting of review of medical plans and identifying means to contain costs. The DCAA review covers essentially the same areas being studied by Coopers & Lybrand.

Example 13: CPSR Review

DCAS performs an annual Contract Procurement System Review (CPSR). Currently, the DCAA is performing a "Material Receiving Audit" which duplicates many of the areas covered in the DCAS reviews.

Other Examples

The following are examples submitted by a defense contractor of duplicative audits from the period of February 1983 - January 1985.

Compensation:

-- Air Force Contract Management Division -- Executive Salary Comparative Study

-- Defense Contract Audit Agency -- Defense Industry Employee Compensation Study -- Sponsored by Deputy Under Secretary of Defense Bill Long

-- DoD Inspector General -- Audit and Study of Executive Compensation (Pilot Study)

-- Air Force Contract Management Division -- Comparative Compensation Study performed by Coopers & Lybrand

-- General Accounting Office -- Comparative Review of all salaries and wages at 12 Aerospace company locations -- responding to Congressman Brooks

-- DoD Inspector General -- Executive Compensation Audit and Study -- 100 selected contractor locations

-- Naval Air Systems Command -- Contracting Officer requests for compensation data on all persons earning more than $100K in 1984 -- Two separate requests for the same data; one addressed to DCAA for contractor data, the other addressed directly to contractor -- stated to be "required by GAO for a compensation review"

-- DCAA -- Oral request

DEPARTMENT OF DEFENSE
INSPECTOR GENERAL
WASHINGTON, D.C. 20301

APR 1985

Honorable Dan Quayle
Chairman, Subcommittee on Defense
Acquisition Policy
Committee on Armed Services
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

The opportunity to testify before your Subcommittee on the coordination of DoD audit activities was greatly appreciated. This is an area that I have given priority attention since becoming the Inspector General, Department of Defense (DoD). While the DoD has more auditors than any other Federal department or agency, the numbers are not that great when you consider the size and complexity of DoD programs and operations. Therefore, we can ill afford to waste any of these valuable audit resources on duplicative or unnecessary audit efforts.

I recognize that it is important for your Subcommittee to receive testimony from all of the parties involved in the acquisition process so that informed decisions can be made on needed improvements to the DoD acquisition process. However, some of the testimony by industry witnesses on DoD audit activities appears to be based on misinformation and misperceptions. Therefore, I believe that it is essential that I provide you with additional information to present a more balanced and accurate portrayal of DoD audit operations.

After I became aware of the testimony before your Subcommittee by senior executives of Lockheed and Martin Marietta on duplicative audits, I requested that my staff investigate the extent of DoD audits involving those two contractors. The investigation did not disclose any evidence of duplicative or excessive audits of those two contractors. Also, on February 14, 1985, I wrote to Messrs. Pownall and Anderson requesting their assistance in identifying the specifics on duplicative and excessive audits. I understand your staff made a similar request. As of this date, responses have not been received on specific examples of duplicative audits.

I am particularly concerned about certain of the comments Messrs. Sauber and Singleton made to your Subcommittee at the hearing on March 12, 1985. The comments by those two gentlemen may leave your Subcommittee with many misconceptions about the roles of DoD audit organizations and the Inspector General, DoD, and the degree of coordination between DoD audit organizations. I have enclosed an analysis, prepared by my staff, of selected comments included in the formal statements of Messrs. Sauber and Singleton.

Some of the industry witnesses made reference to "audit organizations" that are not really audit organizations, but rather contract administration or procurement organizations. For example, the Defense Contract Administration Service is an element of the Defense Logistics Agency that performs contract administration functions. It does not conduct contract audits.

Overall, I believe that DoD has an excellent track record on cooperation and coordination between DoD audit organizations, as well as with the General Accounting Office. While I feel confident about the coordination in the audit community, I do not have the same level of confidence in the effectiveness of coordination between DoD auditors and DoD contract administration and procurement organizations. Because of my concerns, I announced on March 1, 1985, a DoD-wide review of DoD oversight activities involving contractors. The objective of this review will be to determine whether effective coordination exists between the various DoD audit, inspection, contract administration and procurement organizations involved in the oversight of contractors' operations. I will share the results of this review with your Subcommittee.

If you or your staff should desire additional information on the matters discussed in this letter, please have them contact Mr. James H. Curry, my Assistant Inspector General for Audit Policy and Oversight, at 696-5890.

Sincerely,

Joseph H. Sherick
Inspector General

Enclosures

ENCLOSURE 1

OFFICE OF INSPECTOR GENERAL (OIG), DEPARTMENT OF DEFENSE
RESPONSE TO SELECTED COMMENTS BY MR. RICHARD A. SAUBER
BEFORE THE SUBCOMMITTEE ON DEFENSE ACQUISITION POLICY
MARCH 12, 1985

STATEMENT OF MR. SAUBER

"Many of the problems raised by industry and which we will discuss today stem in large measure from a perceived blurring of the lines between the function of DCAA and of the IG." (Page 2 of prepared statement by Mr. Richard A. Sauber)

OIG, DOD, RESPONSE

The blurring of lines perceived by Mr. Sauber are not borne out by events in the real world. The responsibilities for the DCAA and IG, DoD, are clearly set forth in DoD directives and enabling legislation. The DoD Directive 5105.36, "Defense Contract Audit Agency," dated June 8, 1978, (TAB A) provides that:

"B. MISSION

DCAA shall:

1. Perform all necessary contract audit for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration..."

"C. ORGANIZATION AND MANAGEMENT

2. No separate contract audit organization independent of the DCAA shall be established in the Department of Defense."

The audit element of the IG, DoD, is classified as an internal audit organization. The DoD Directive 7600.2, "Audit Policies," dated January 10, 1985 (TAB B) provides under paragraph D.3.b. that:

"The DoD internal audit organizations are responsible for auditing the performance of DoD procurement and contract administration officials."

In reviewing the operations of DoD procurement and contract administration officials, it is necessary, at times, for DoD internal audit organizations to review contractors' records. This need was recognized by the Congress in connection with enabling legislation to establish an Inspector General in the Department of Defense. The following is an excerpt from the conferees report on the enabling legislation:

> "...Instead, the conferees agreed to direct the Secretary of Defense to transfer not less than 100 additional positions to the Office of Inspector General to be filled by the Inspector General with persons trained to perform contract audit. The conferees believe that the new Inspector General will develop a significant capability in the highly technical areas of contract audit. The conferees do not intend that these auditors advise Department of Defense contracting officers in the process of negotiating contracts, a function that the Defense Contract Audit Agency performs. The conferees envision the contract audit capability in the Office of the Inspector General to be used (1) to provide the manpower and technical expertise to oversee effectively and review the work of the Defense Contract Audit Agency, and (2) to provide the Inspector General flexibility and resources in situations where he deems it necessary or appropriate to look at entire procurements--the performance of defense contractors as well as the performance of defense personnel."

The IG, DoD, has abided by the direction of the Congress in the performance of all audit work involving contractors.

STATEMENT OF MR. SAUBER

"The first issue concerns the duplication of audit function by government agencies...Such organizations as the IG, DCAA, the Defense Contract Administration Service, and the audit components of the individual military departments ought to be able to coordinate." (Page 2)

OIG, DOD, RESPONSE

The Defense Contract Administration Service is not a DoD audit organization. The Defense Contract Administration Service is responsible for the administration of those DoD contracts not administered by the Military Departments.

Department of Defense audit policy guidance requires DoD audit organizations to coordinate and cooperate with each other and the General Accounting Office in the performance of their audit work. The internal audit organizations exchange annual audit plans and copies of these plans are provided to the General Accounting Office. The IG, DoD, sponsors joint planning activities with the Military Department internal audit organizations to identify areas that warrant DoD-wide coverage on a coordination. Several highly effective and successful DoD-wide audits have been accomplished.

With respect to the coordination of audit work by DoD internal audit organizations and the DCAA, paragraph D.6.b., of DoD Directive 7600.2, provides that:

> "Normally, the DoD internal audit and internal review organizations will obtain information relative to contractors' records from DCAA. If DCAA is unable to provide the required assistance for audit services, the internal audit and internal review organizations may review contractor records, as needed, to accomplish their assigned responsibilities. However, DoD internal audit and internal review organizations shall coordinate all reviews involving contractor records with the DCAA and the appropriate contract administration office to avoid duplication of audit work."

Additional guidance on the coordination between DoD internal audit organizations and the DCAA is contained in Inspector General Contract Audit Policy Memorandum Number 1, "Relationships Between Contract and Internal Audit Organizations" (TAB C). The DoD audit organizations are also required to coordinate and cooperate with other DoD investigation, inspection and management groups to avoid duplication.

Recent examples of coordination and cooperation between DoD internal audit and contract audit organizations are the spare parts and defective pricing audits. The spare parts audit, the largest audit ever conducted in the DoD, involved about 300 auditors from the Office of the Inspector General, DoD; the Military Departments and the DCAA. Over 200 contractor locations were included. The Office of the Inspector General, DoD, and the Military Department auditors performed work at DoD procurement activities, and the DCAA performed the work at contractor locations.

The spare parts audit disclosed a number of contractors that consistently charged the DoD unreasonable prices for spare parts. A a result, the IG concluded that it was appropriate to

conduct extensive defective pricing reviews at 95 contractor locations. The DCAA is performing those defective pricing audits at those contractor locations where it has resident field audit offices. The IG auditors are performing such audits at those smaller contractor locations where DCAA does not have resident offices.

STATEMENT OF MR. SAUBER

"In my own experience, many of the duplicative functions arise not just because of lack of communications but because of a disagreement over policy matters." (Page 3)

OIG, DOD, RESPONSE

Mr. Sauber did not provide any specifics in his statement to support his opinion. Moreover, to our knowledge, Mr. Sauber does not possess any extensive knowledge or experience concerning the internal operations of DoD audit organizations.

Our review of audit activities involving Lockheed and Martin Marietta locations over the last year did not disclose any indications of duplicative audit work by DoD audit oganizations. Also, the Assistant Secretary of Defense (Comptroller) concluded in his prepared statement that:

> "Regarding coo dination of audit activities, we believe we are experiencing outstanding success. When the Inspector General or the GAO starts an audit requiring access to contractors' records or facilities, they usually meet with DCAA to find out what work in the area has already been done by DCAA and how they can utilize DCAA's work in accomplishing their audit objectives...."

STATEMENT OF MR. SAUBER

"In our view, such automatic access (to internal audit reports) by DCAA may, in fact, be contrary to the taxpayers' interest for some very basic resons." Words in parenthesis added. (Page 4)

OIG, DOD, RESPONSE

Such a statement reflects a misunderstanding of the role of corporate internal auditing and the use of these reports by the DCAA in accomplishing their audit work. Access to such reports is in the taxpayers' interest and, accordingly, most major DoD contractors provide DCAA with access to corporate internal audit reports.

A major responsibility of corporate internal audit groups is to evaluate the effectiveness of internal control systems. The maintenance of effective internal control systems is essential to the prevention of fraud, waste and mismanagement. The importance of sound internal controls was recognized by the Congress in the passage of the Foreign Corrupt Practice Act of 1977. This law requires corporations to maintain effective internal control systems. When corporate internal audit groups find fraud or waste in programs that involve DoD contracts, it is in the taxpayers' interest that appropriate remedial actions be taken.

In performing their audit work, DCAA auditors are required to follow auditing standards issued by the American Institute of Certified Public Accountants. These standards require that the DCAA auditors consider the adequacy of internal controls in determining the scope of audit work. A primary source of information on the adequacy of such internal controls is the audit reports of the corporate internal audit department. Moreover, to the extent that the corporation has a quality internal audit department, DCAA auditors can further reduce their work and rely upon the audit work performed by the corporate internal auditors. Such reductions in audit costs benefit both the DoD, the contractor, and the taxpayers.

Currently, DoD pays its share of corporate internal audit department costs through charges to contract overhead. Even if DoD were not to pay for such costs, it is in the best interest of the DoD and the taxpayers that DCAA have access to such reports.

STATEMENT OF MR. SAUBER

"Many companies, even when the information is protected by attorney-client privilege, have made full and voluntary disclosures about severe internal problems to the Department of Defense." (Page 5)

OIG, DOD, RESPONSE

This is true and we encourage such actions by responsible DoD contractors. However, we are also aware of situations where contractors have refused access to corporate internal audit reports dealing with fraudulent matters that impacted upon DoD contracts and have erected roadblocks to slow our investigative process.

STATEMENT OF MR. SAUBER

"DCAA access to a whole range of other kinds of financial and business planning records seems unnecessary for a number of different reasons." (Page 5)

OIG, DOD, RESPONSE

Mr. Sauber does not identify the specific financial and business planning records or reasons why DCAA should not have access to such records. The DCAA, not the contractor, is in the best position to determine what records it requires to perform its audit mission. To the extent that differences exist, such access matters are elevated through appropriate channels for resolution.

STATEMENT OF MR. SAUBER

"To the extent that there has been some blurring of these lines (between contract auditors and criminal investigators) it has, in our judgment, redounded to the detriment of the United States by placing limitations on the effectiveness of the DCAA auditors." Words in parethesis added. (Page 7)

OIG, DOD, RESPONSE

The responsibilities of DoD audit and investigative organizations are clearly delineated in DoD directives. The auditors do not conduct criminal investigations and the investigators do not conduct audits.

A formal Memorandum of Understanding between DCAA and the DoD criminal investigative organizations provides guidance on the procedures to be followed when potential fraudulent activities are detected by DCAA auditors. When DCAA auditors detect any indications of possible fraudulent activities, they are required to provide an immediate fraud alert to the appropriate DoD criminal investigative organization. The DoD criminal investigative organization will then determine whether a formal investigation should be opened.

In many cases, the technical assistance of contract auditors is required by the criminal investigators to conduct an appropriate investigation. The DCAA auditors are in the best position to assist the criminal investigators because of their knowledge of contractor accounting practices. In such situations, the DCAA auditors work under the general supervision of the criminal investigators and perform an investigative function, not an audit function. All formal investigations are announced to the contractor in advance of the start of the investigation.

STATEMENT OF MR. SAUBER

"The perception among contractors that the lines (between contract auditors and criminal investigators) have been blurred is not a wild fantasy. One need look no further than the Westinghouse case." Words in parenthesis provided. (Page 7)

OIG, DOD, RESPONSE

The Westinghouse case, alluded to by Mr. Sauber, has nothing to do with criminal investigative matters. It involves access to records of the Westinghouse Electric Corporation that are required by the IG to perform his statutory function. The IG issued a subpoena for those records to Westinghouse in September 1984. Westinghouse subsequently refused to honor the subpoena, and the matter is now before the Federal courts.

STATEMENT OF MR. SAUBER

"In fashioning some rules about having clear-cut differentiation between auditors and the investigators, it might be instructive to look at the IRS area where a rather expansive body of law has been developed concerning the difference between civil audits and criminal investigations." (Page 8)

OIG, DOD, RESPONSE

The DoD already has sufficient guidance that clearly differentiates the roles of auditors and criminal investigators.

STATEMENT OF MR. SAUBER

"We would like to add another item where the blurring of lines of authority also occurs at times. The IG and procurement policy functions in the Pentagon have recently overlapped in a number of instances." (Page 8)

OIG, DOD, RESPONSE

Mr. Sauber did not provide any specifics to support his allegation on overlap. The IG has not issued procurement policy, nor has the authority to do so. This is the sole responsibility of DoD management. The role of the IG in the development and implementation of procurement policy is of an advisory nature.

8

The Inspector General Act of 1978, as amended, requires the IG to review existing and proposed regulations relating to DoD programs and operations. In line with this statutory responsibility, the IG provide comments on proposed changes to acquisition regulations and draft DoD directives dealing with procurement policy matters. He also evaluates the implementation of DoD procurement policy as part of normal audits and makes recommendations to management for improvements.

STATEMENT OF MR. SAUBER

"It is not in our judgment for the Inspector General to use his powers to enhance or enforce either the audit rights or make audit policy for DCAA." (Page 9)

OIG, DOD, RESPONSE

We strongly disagree with this statement. The Inspector Genera Act of 1978, as amended, assigned the IG policy and oversight responsibilities for all DoD audit organizations.

RECOMMENDATION OF MR. SAUBER

"1. The DCAA should have and maintain jurisdiction as the sole audit authority in the areas of cost, pricing and verification of the adequacy of internal controls directly pertinent to contract performance." (Page 9)

OIG, DOD, RESPONSE

The recommended action has been and continues to be the DoD position. The DCAA is the sole contract audit agency for the review of contract proposals and providing support and advice to contracting officers. However, the Congress specifically ordered the transfer of not less than 100 contract audit personnel to the Inspector General, DoD, to give the Inspector General a "significant capability in the highly technical areas of contract audit." The law provides the Inspector General with the authority and responsibility to audit entire procurements including the performance of defense contractors.

RECOMMENDATION OF MR. SAUBER

"2. Distinct lines should be drawn between audit and investigative functions." (Page 10)

OIG, DOD, RESPONSE

Distinction already exists between the functions and responsibilities of DoD audit and criminal investigative organizations.

RECOMMENDATION OF MR. SAUBER

"3. The IG, DoD, should have a strong oversight and review function, but should rely on other DoD organizations to make and implement procurement and audit policy." (Page 10)

OIG, DOD, RESPONSE

As previously stated, the IG does not make nor implement DoD procurement policy. We believe that the Congress made a proper decision in assigning both audit policy and oversight responsibilities to the IG. If the IG is to have overall responsibility for the adequacy of audit coverage of DoD programs and operations, then it is necessary and appropriate that he also have policy responsibilities.

ENCLOSURE 2

OFFICE OF INSPECTOR GENERAL (OIG), DEPARTMENT OF DEFENSE
RESPONSE TO SELECTED COMMENTS BY MR. RICHARD SINGLETON
BEFORE THE SUBCOMMITTEE ON DEFENSE ACQUISITION POLICY
MARCH 12, 1985

STATEMENT OF MR. SINGLETON

"The following list indicates the current level of government audit and review activities which my division has undergone over the past four months:

1. Routine Defense Contract Audit Agency Efforts
2. Routine Defense Logistics Agency Efforts
3. Department of Defense Inspector General Post Award Audit of 18 Contracts
4. Department of Defense Inspector General Executive Compensation Audit
5. Defense Logistics Agency Employee and Executive Compensation Review
6. Defense Logistics Agency--Government Property Survey
7. Naval Air Systems Command Should Cost Review
8. Defense Contract Audit Agency Independent Research and Development and Bid and Proposal Audit
9. Defense Contract Audit Agency Post Award Audit
10. Defense Contract Audit Agency Cost System Information Request
11. Defense Logistics Agency Purchasing System Review"

OIG, DOD, RESPONSE

The Defense Logistics Agency and the Naval Air Systems Command are not DoD audit organizations. The Defense Contract Administration Service of the Defense Logistics Agency is responsible for the administration of DoD contracts at the Applied Technology Division of Litton Industries. The Naval Air Systems Command is a DoD procurement organization.

The extent of audit work conducted at the Applied Technology Division by DoD audit organizations during the subject four months is not considered to be excessive or duplicative. During the four month period, the Defense Contract Audit Agency (DCAA) performed 304 hours of audit work at the Applied Technology Division. Of those hours, 233, or 71 percent, involved the review of a $20 million contract proposal. Also, to preclude duplicative effort, the DCAA auditors jointly

participated with the Defense Contract Administration Service in reviews of compensation (item number 5) and purchasing systems (item number 11). The DCAA auditors expended 24 hours on these joint reviews.

Item number 3, involves a defective pricing audit of contracts awarded to Itek Corporation (acquired by Litton in 1983 and now part of Applied Technology Division) between FY 1979 and FY 1983. This is a follow on audit to the spare parts audit and involves about 95 contractors who billed spare parts to the DoD at unreasonable prices. This is a joint effort involving DCAA and the Inspector General. The DCAA generally is performing audits at those contractor locations where they have resident audit staffs. The Inspector General is performing audits at other contractor locations.

The compensation audit identified in item number 4 differs in a major way from the compensation reviews performed by other DoD organizations. The objective of the audit is to compare the salaries for selected senior executive positions of about 100 Defense contractors with executive compensation for similar positions in non-Defense related industries.

The Defense Contract Administration Service is responsible for all reviews of contractor compensation. Their reviews are generally limited to a specific contractor location and focus on the reasonableness of wages for various labor categories. Little emphasis is placed on executive compensation. About a year ago, the Air Force completed two studies on executive compensation in the aerospace and electronics industries. These studies were very limited as to sample size and scope. The same situation existed in a recent General Accounting Office study of executive compensation in the aerospace industry. The DCAA recently started a review of compensation, but the review is restricted to nonexecutive compensation. Thus, while there may be an appearance of duplication, there has not been a proper audit of executive compensation.

STATEMENT OF MR. SINGLETON

"Even more importantly, in our view, this important proposal audit activity has been subordinated to post award and operational audits." (Page 4)

OIG, DOD, RESPONSE

Contrary to the implictions by Mr. Singleton, proposal audits are the number one priority of DCAA and accounted for 46 percent of their total audit work for the 12-month period ending June 30, 1984. This is further substantiated in the

prepared statement of the Assistant Secretary of Defense (Comptroller) in which he states that:

> "On a day-to-day basis, the most urgent requirement for DCAA's services relates to the award and modification of contracts. This is priority No. 1."

As for post award and operational audits, those areas accounted for 30 percent and 3 percent, respectively, of DCAA's audit activities for the subject 12-month period. Since contractor proposals include recovery of all indirect and direct costs (full absorption costing), the DCAA auditors need to review the efficiency and economy of contractor operations to determine the reasonableness of contractor costs.

STATEMENT OF MR. SINGLETON

"If proper attention were given to the original proposal, procurement costs would be reduced by eliminating the repetition of the proposal update efforts."

OIG, DOD, RESPONSE

The primary factor contributing to proposal update efforts is deficiencies in the original proposals submitted by contractors. In many cases, the contractors do not provide sufficient supporting data to permit DCAA auditors to review the reasonableness of proposed contract costs.

STATEMENT OF MR. SINGLETON

"In the past year, the Department of Defense Inspector General has initiated its own post award audits on a larger scale then was previously evident." (Page 4)

OIG, DOD, RESPONSE

The only post award review initiated to date by the Inspector General involves the previously mentioned defective pricing audits. This is a joint effort between DCAA and the Inspector General and is designed to only audit those contractors who were found to have charged unreasonable prices for spare parts.

STATEMENT OF MR. SINGLETON

"The Department of Defense should limit its involvement to the evaluation of the reasonableness of costs and assurance that the actual expenses charged to government contracts are properly allocable and allowable by regulation."

OIG, DOD, RESPONSE

The primary objective of DCAA audits is to determine the reasonableness, allowability and allocability of proposed or claimed contract costs.

STATEMENT OF MR. SINGLETON

"Our observation is that the Government is not now adequately staffed, both in numbers and experience, to effectively carry out the basic audit roles which I have outlined above." (Page 5)

OIG, DOD, RESPONSE

The Assistant Secretary of Defense (Comptroller) has recognized the need to add additional auditor positions in DCAA because of the significant increases in audit workload. In fiscal year 1984, 387 auditor positions were approved. An additional 200 auditor positions have been requested for fiscal year 1986. The DCAA has an excellent training program to maintain the technical proficiency of its staff. The DCAA Institute provided training to almost 2,600 DCAA auditors last year.

STATEMENT OF MR. SINGLETON

We also take note that the Inspector General is adding approximately 2,900 auditors to its staff." (Page 5)

OIG, DOD, RESPONSE

This is not true. In fact, the total authorized strength of the entire OIG, DoD, is only 1,091, which includes 526 auditors. Since the formation of the IG in fiscal year 1983, 23 new auditor positions have been authorized. Small increases have been requested for future years.

STATEMENT OF MR. SINGLETON

"The Department of Defense should allocate more of its limited audit resources to proposal audits." (Page 7)

OIG, DOD, RESPONSE

The DCAA currently allocates about 50 percent of its resources to proposal audits. All requests by contracting officers for audits of contract proposals are honored on a priority basis by DCAA.

STATEMENT OF MR. SINGLETON

"The Department of Defense should limit its use of post award audits of fixed price contracts to instances of suspected fraud or abuse."

OIG, DOD, RESPONSE

Post award audits of fixed price contracts are limited to determining the compliance of the contractor with P.L. 87-653, Truth in Negotiations Act. In conducting such defective pricing audits, DCAA auditors are sensitive to indications of fraud.

ENCLOSURE 3

June 8, 1978
NUMBER 5105.36

ASD(C)

Department of Defense Directive

SUBJECT Defense Contract Audit Agency

References: (a) DoD Directive 5105.36, "Defense Contract Audit Agency," June 9, 1965 (hereby cancelled)
(b) DoD Directive 5000.19, "Policies for the Management and Control of Information Requirements," March 12, 1976

A. PURPOSE

Pursuant to authority vested in the Secretary of Defense under the provisions of title 10, United States Code, this Directive reissues reference (a) and establishes the Defense Contract Audit Agency (hereafter referred to as "DCAA") with responsibilities, functions, authorities, and relationships as outlined below.

B. MISSION

DCAA shall:

1. Perform all necessary contract audit for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. These services will be provided in connection with negotiation, administration, and settlement of contracts and subcontracts.

2. Provide contract audit service to other Government agencies as appropriate.

C. ORGANIZATION AND MANAGEMENT

1. DCAA is established as a separate agency of the Department of Defense under the direction, authority and control of the Assistant Secretary of Defense (Comptroller). It shall consist of a Director and such subordinate organizational elements as are established by the Director within resources authorized by the Secretary of Defense.

2. No separate contract audit organization independent of the DCAA shall be established in the Department of Defense.

D. RESPONSIBILITIES AND FUNCTIONS

The Director, DCAA shall:

1. Organize, direct, and manage the DCAA and all resources assigned to the DCAA.

2. Assist in achieving the objective of prudent contracting by providing DoD officials responsible for procurement and contract administration with financial information and advice on proposed or existing contracts and contractors, as appropriate.

3. Audit, examine and/or review contractors' and subcontractors' accounts, records, documents, and other evidence; systems of internal control; accounting, costing, and general business practices and procedures; to the extent and in whatever manner is considered necessary to permit proper performance of the other functions described in 4 through 12 below.

4. Examine reimbursement vouchers received directly from contractors, under cost-type contracts, transmitting those vouchers approved for payment to the cognizant Disbursing Officer and issuing DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with a copy to the cognizant contracting officer, with respect to costs claimed but not considered allowable. Where the contractor disagrees with a suspension or disallowance action by DCAA, and the difference cannot be resolved, the contractor may appeal in writing to the Administrative Contracting Officer (ACO) who will make his determination in writing. In adddition, the contracting officer may direct the issuance of DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with respect to any cost which he has reason to believe should be suspended or disapproved.

5. Provide advice and recommendations to procurement and contract administration personnel on:

a. Acceptability of costs incurred under redeterminable, incentive and similar type contracts.

b. Acceptability of incurred costs and estimates of cost to be incurred as represented by contractors incident to the award, negotiation, modification, change, administration, termination, or settlement of contracts.

c. Adequacy of financial or accounting aspects of contract provisions.

d. Adequacy of contractors' accounting and financial management systems, adequacy of contractors' estimating procedures and adequacy of property controls.

6. Assist responsible procurement or contract administration activities in their surveys of the purchasing-procurement systems of major contractors.

7. Direct audit reports to the Government management level having authority and responsibility to take action on the audit findings and recommendations.

8. Cooperate with other appropriate Department of Defense components on reviews, audits, analyses, or inquiries involving contractors' financial position or financial and accounting policies, procedures, or practices.

9. Establish and maintain liaison auditors as appropriate at major procuring and contract administration offices.

10. Review General Accounting Office reports and proposed responses thereto which involve significant contract or contractor activities for the purpose of assuring the validity of appropriate pertinent facts contained therein.

11. In an advisory capacity, attend and participate, as appropriate, in contract negotiation and other meetings which contract cost matters, audit reports, or related financial matters are under consideration.

12. Provide assistance, as requested in the development of procurement policies and regulations.

13. Perform such other functions as the Assistant Secretary of Defense (Comptroller) may from time to time prescribe.

E. AUTHORITY

The Director, DCAA, is specifically delegated authority to:

1. Have free and unrestricted access to and direct communication with all elements of the Department of Defense and other executive departments and agencies as necessary.

2. Establish Defense Contract Audit Agency facilities using appropriate established physical facilities and services of other DoD components whenever practicable to achieve maximum efficiency and economy.

3. Obtain such information, consistent with the policies and criteria of DoD Directive 5000.19, (reference (b)) advice, and assistance from DoD components as he deems necessary.

4. Exercise the administrative authorities contained in enclosure 1 of this Directive.

F. RELATIONSHIPS

1. In the performance of his functions, the Director, DCAA shall:

a. Maintain appropriate liaison with other components of the DoD, other agencies of the Executive Branch, and the General Accounting Office for the exchange of information and programs in the field of assigned responsibilities.

b. Make full use of established facilities in the Office of the Secretary of Defense, other DoD components, and other Governmental agencies rather than unnecessarily duplicating such facilities.

c. The military departments and other DoD components shall provide support, within their respective fields of responsibility, to the Director, DCAA to assist in carrying out the assigned responsibilities and functions of the Agency. Programming, budgeting and financing for such support will be in accordance with policies and procedures prescribed by the Assistant Secretary of Defense (Comptroller).

2. Procurement and contract administration activities of the DoD components shall utilize audit services of the DCAA to the extent appropriate in connection with the negotiation, administration, and settlement of contract payments and prices which are based on cost (incurred or estimated), or on cost analysis.

G. ADMINISTRATION

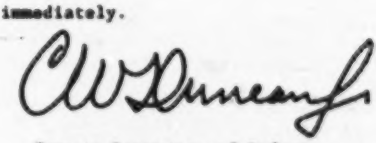
1. The Director, DCAA, shall be a civilian selected by the Secretary of Defense.

2. The appointment of other personnel to the Agency will be subject to the approval of the Director, DCAA.

3. DCAA will be authorized such personnel, facilities, funds, and other administrative support as the Secretary of Defense deems necessary.

H. EFFECTIVE DATE

This Directive is effective immediately.



Deputy Secretary of Defense

Enclosure - 1
Delegations of Authority

DELEGATIONS OF AUTHORITY

Pursuant to the authority vested in the Secretary of Defense, and subject to his direction, authority, and control, and in accordance with DoD policies, directives, and instructions, the Director, DCAA, or, in the absence of the Director the person acting for him, is hereby delegated authority as required in the administration and operation of DCAA to:

1. Exercise the powers vested in the Secretary of Defense by 5 USC 301, 302(b) and 3101 pertaining to the employment, direction and general administration of DCAA civilian personnel.

2. Fix rates of pay for wage board employees exempted from Civil Service classification by 5 USC 5102(c)(7) on the basis of prevailing rates for comparable jobs in the locality where each installation is located.

3. Establish advisory committees and employ part-time advisers pursuant to the provisions of 10 USC 173, 5 USC 3109(b), the Federal Advisory Committee Act, and the Agreement between the Department of Defense (DoD) and the Civil Service Commission on employment of experts and consultants, dated March 14, 1975.

4. Administer oaths of office incident to entrance into the Executive Branch of the Federal Government or any other oath required by law in connection with employment therein, in accordance with the provisions of 5 USC 2903, and designate in writing, as may be necessary, officers and employees of DCAA to perform this function.

5. Establish a DCAA Incentive Awards Board and pay cash awards to, and incur necessary expenses for the honorary recognition of civilian employees of the Government whose suggestions, inventions, superior accomplishments or other personal efforts, including special acts or services, benefit or affect DCAA or its subordinate activities in accordance with the provisions of 5 USC 4503 and Civil Service Regulations.

6. In accordance with the provisions of 5 USC 7532; Executive Order 10450, dated April 27, 1953, as amended; and DoD Directive 5210.7, "Department of Defense Civilian Applicant and Employee Security Program," September 2, 1966:

a. Designate any position in DCAA as a "sensitive" position;

b. Authorize, in case of an emergency, the appointment of a person to a sensitive position in the Agency for a limited period of time for whom a full field investigation or other appropriate investigation, including the National Agency Check, has not been completed; and

c. Authorize the suspension, but not to terminate the services of an employee in the interest of national security in positions within DCAA.

7. Clear DCAA personnel and such other individuals as may be appropriate for access to classified Defense material and information in accordance with the provisions of DoD Directive 5210.8, "Policy on Investigation and Clearance of DoD Personnel for Access to Classified Defense Information," February 15, 1962, and of Executive Order 11652, dated March 8, 1972, as amended.

8. Act as agent for the collection and payment of employment taxes imposed by Chapter 21 of the Internal Revenue Code of 1954 and, as such agent, make all determinations and certifications required or provided for under Section 3122 of the Internal Revenue Code of 1954 and Section 205(p)(1) and (2) of the Social Security Act, as amended (42 USC 405(p)(1) and (2)) with respect to DCAA employees.

9. Authorize and approve overtime work for DCAA civilian officers and employees in accordance with the provisions of the Federal Personnel Manual Supplement 990-1, Section 550.111.

10. Authorize and approve:

a. Travel for DCAA civilian officers and employees in accordance with Joint Travel Regulations, Volume 2, DoD Civilian Personnel;

b. Temporary duty travel only for military personnel assigned or detailed to DCAA in accordance with Joint Travel Regulations, Volume 1, Members of Uniformed Services; and

c. Invitational travel to persons serving without compensation whose consultive, advisory or other highly specialized technical services are required in a capacity that is directly related to, or in connection with DCAA activities, pursuant to the provisions of 5 USC 5703.

11. Approve the expenditure of funds available for travel by military personnel assigned or detailed to DCAA for expenses incident to attendance at meetings of technical, scientific, professional or other similar organizations in such instances where the approval of the Secretary of Defense or his designee is required by law (37 USC 412). This authority cannot be redelegated.

12. Develop, establish and maintain an active and continuing Records Management Program, pursuant to the provisions of Section 506(b) of the Federal Records Act of 1950 (44 USC 3102), the Freedom of Information Act Program (5 USC 552) and the Privacy Act Program (5 USC 552a).

13. Establish and use Imprest Funds for making small purchases of material and services other than personal for DCAA when it is determined more advantageous and consistent with the best interests of the Government, in accordance with the provisions of DoD Instruction 5100.71, "Delegation of Authority and Regulations Relating to Cash Held at Personal Risk Including Imprest Funds," March 5, 1973, and the Joint Regulation of the General Services Administration/Treasury Department/ General Accounting Office, entitled "For Small Purchases Utilizing Imprest Funds."

14. Authorize the publication of advertisements, notices or proposals in newspapers, magazines or other public periodicals as required for the effective administration and operation of DCAA (44 USC 3702).

15 Establish and maintain appropriate Property Accounts for DCAA and appoint Boards of Survey, approve reports of survey, relieve personal liability, and drop accountability for DCAA property contained in the authorized Property Accounts that has been lost, damaged, stolen, destroyed or otherwise rendered unserviceable, in accordance with applicable laws and regulations.

16. Promulgate the necessary security regulations for the protection of property and places under the jurisdiction of the Director, DCAA, pursuant to subsections III.A. and V.B. of DoD Directive 5200.8, "Authority of Military Commanders under the Internal Security Act of 1950 to Issue Security Orders and Regulations for the Protection of Property or Places under Their Command," August 20, 1954.

17. Establish and maintain, for the functions assigned, an appropriate publications system for the promulgation of common supply and service regulations, instructions, and reference documents, and changes thereto, pursuant to the policies and procedures prescribed in DoD Directive 5025.1, "Department of Defense Directive System," November 18, 1977.

18. Enter into support and service agreements with the Military Departments, other DoD agencies, or other Government agencies as required for the effective performance of responsibilities and functions assigned to DCAA.

The Director, Defense Contract Audit Agency, may redelegate these authorities, as appropriate, and in writing, except as otherwise specifically indicated above or as otherwise provided by law or regulation.

This delegation of authorities is effective immediately.

ENCLOSURE 4

Department of Defense
DIRECTIVE

January 10, 1985
NUMBER 7600.2

IG, DoD

SUBJECT: Audit Policies

References: (a) DoD Directive 7600.2, subject as above, August 7, 1978 (hereby canceled)
(b) Office of Management and Budget (OMB) Circular A-73 "Audit of Federal Operations and Programs," June 20, 1983
(c) Comptroller General of the United States, "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions," February 27, 1981
(d) DoD Directive 5106.1, "Inspector General of the Department of Defense," March 14, 1983
(e) through (m), see enclosure 1

A. REISSUANCE AND PURPOSE

This Directive:

1. Reissues reference (a) to update policies, procedures, and responsibilities.

2. Implements references (b), (c), and (d).

B. APPLICABILITY

1. This Directive applies to the Office of the Secretary of Defense (OSD), the Military Departments, the Organization of the Joint Chiefs of Staff (OJCS), the Inspector General, Department of Defense (IG, DoD), the Unified and Specified Commands, and the Defense Agencies (hereafter referred to collectively as "DoD Components"). The term "Military Services," as used herein, refers to the Army, the Navy, the Air Force, and the Marine Corps.

C. DEFINITION

DoD Audit Organizations. The Office of the Inspector General, Department of Defense (OIG, DoD); the Defense Contract Audit Agency (DCAA); the elements of the U.S. Army Corps of Engineers that perform contract audits; the internal audit and internal review organizations of the DoD Components; and the military exchange audit organizations.

D. POLICY

It is DoD policy to provide adequate audit coverage of all DoD organizations, programs, activities, and functions as an integral part of the DoD management system. The objectives of auditing are to conduct independent evaluations of

DoD programs and operations, and to determine whether internal control systems are adequate; information is reliable; applicable laws, regulations and policies are followed; resources are safeguarded and managed economically and efficiently; and desired program results are achieved.

E. RESPONSIBILITIES

1. The Inspector General, Department of Defense, shall establish and monitor adherence to standards, policies, and procedures for the performance of audits in the Department of Defense as set forth in DoD Directive 5106.1 and Pub. L. 95-452 (references (d) and (e)).

2. The Assistant Inspector General for Audit Policy and Oversight, Office of the Inspector General, Department of Defense, shall:

a. Provide audit policy guidance for all DoD audit organizations for the purpose of improving the efficiency, effectiveness, and quality of DoD audit operations.

b. Conduct external reviews of DoD audit organizations to evaluate the efficiency and effectiveness of operations and ensure compliance with DoD auditing standards, policies, and procedures. These external reviews may be conducted with internal resources or peer review teams composed of representatives from the various DoD audit organizations.

c. Ensure that audit responsibilities are assigned for all DoD programs and operations, particularly those programs that have interservice implications such as executive agent and single manager arrangements.

3. The Assistant Inspector General for Auditing, Office of the Inspector General, Department of Defense, shall:

a. Perform internal audits of and provide internal audit services to the OSD, the OJCS, the Unified Commands and their Military Assistance Advisory Groups and Missions, and the Defense Agencies.

b. Perform audits of selected aspects of operations involving two or more DoD Components (inter-Service audits) within the DoD Components.

c. Perform audits of the entire procurement process, including the performance of contractors and DoD contracting officials.

d. Perform audits of activities, programs, or functions solely within one of the Military Services, if the cognizant Military Service audit activity is unable to provide the audit coverage needed.

e. Conduct other audits as the IG, DoD, considers appropriate.

4. The Assistant Secretary of Defense (Comptroller) shall maintain authority, direction, and operational control over the DCAA, including responsibility for the effectiveness and scope of the Agency's activities.

5. The Director, Defense Contract Audit Agency, shall provide contract audit functions worldwide for all DoD Components as prescribed in DoD Directive 5105.36 (reference (f)).

6. The Secretaries of the Military Departments shall maintain authority, direction, and operational control over their internal audit and internal review organizations and shall ensure their effective and efficient operation consistent with this Directive, and shall:

a. Except as provided in subsection E.3., above, have internal audit cognizance of Specified Commands and Military Department Components of Unified and subordinate Unified Commands.

b. Ensure that all internal audit responsibilities within a military exchange system are carried out by a single exchange audit organization to ensure independence and to avoid duplication.

c. Ensure internal audit responsibilities within each Military Department are carried out by a single audit organization headed by a civilian Auditor General.

7. The Heads of DoD Components, in their relationships with DoD audit organizations, shall:

a. Recognize and support the audit function as an important element of the managerial control system, and utilize fully audit services and results.

b. Assist the auditor in determining what security clearances will be needed and, when appropriate, brief the auditor for access to a special access program.

c. Make decisions on whether auditors should be denied information as provided for in subsection F.15. of this Directive.

d. Assist the auditor in obtaining full and timely access to such contractor personnel, facilities, and records as provided for under applicable laws, regulations, and contract provisions.

e. Provide suitable office space and facilities or render appropriate assistance to the audit organizations in obtaining an acceptable worksite.

f. Provide prompt, responsive, and constructive management consideration and comments to draft findings and recommendations developed during the course of an audit, to the draft audit reports, and to the auditor's estimates of the related monetary benefits. Policies and procedures on the disposition and followup of audit findings and recommendations in final audit reports are contained in DoD Directives 7650.3 and 7640.2 (references (g) and (h)).

g. Provide their audit organizations with resources (personnel and funds) necessary for the effective and efficient accomplishment of assigned audit functions.

F. PROCEDURES

1. Internal Audit. The overall objective of internal audit is to assist DoD management in attaining its goals by furnishing information, analyses, appraisals, and recommendations pertinent to DoD management duties and

objectives. Auditors independently and objectively shall analyze, review, and evaluate existing procedures, controls, and performance relating to organizations, activities, programs, and functions; and shall present conditions, conclusions, and recommendations constructively in such a way as to stimulate or encourage corrective action.

2. Internal Review. DoD Components may establish internal review organizations to provide local commanders with an internal audit capability to resolve known or suspected problem areas and operational deficiencies, and to supplement the audit services provided by the cognizant internal audit organization. Internal review organizations shall function similarly to internal audit organizations, except that they shall report to the commander of their respective field organizations. Their overall function is to furnish the commander with an independent and objective evaluation of operations and related internal controls. The internal review staff may not be used to perform operating tasks. Internal review organizations may be used to perform audit liaison and audit followup on internal audits by others, and to assist commanders in evaluating the adequacy of vulnerability assessments and internal control reviews. The cognizant internal audit organization shall provide technical and training assistance, and shall conduct periodic evaluations of the effectiveness of internal review organizations.

3. Contract Audit

a. Contract auditors review contractor records for the purpose of providing independent audit services to DoD procurement and contract administration officials for use in the negotiation, administration, and settlement of contracts and subcontracts. This involves the audit, examination, and review of contractors' and subcontractors' accounts, records, documents, and other evidence; systems of internal control; and accounting, costing, and general business practices and procedures, to determine whether incurred costs or estimates of costs for contracts and subcontracts are reasonable and acceptable.

b. The DoD internal audit organizations are responsible for auditing the performance of DoD procurement and contract administration officials.

4. Audit Standards. In the performance of audits of DoD programs and operations, DoD audit organizations shall comply with those standards and policies issued by Office of Management and Budget (OMB) and the Comptroller General of the United States (references (b) and (c)), as well as those issued by the President's Council on Integrity and Efficiency and the IG, DoD. The standards in reference (c) for financial and compliance audits incorporate the American Institute of Certified Public Accountant's "Codification of Statements on Auditing Standards" issued in 1981. Future statements will be adopted by DoD audit organizations, unless the Comptroller General excludes them by formal announcement.

5. Independence. To obtain the greatest benefit of audit, DoD audit organizations and individual auditors shall be free from personal and external impairments to independence, and shall be independent organizationally. Except for internal review, each DoD audit organization shall report to the head of the DoD Component. Internal review organizations shall report to the

head or deputy head of a command or activity and shall be located outside of the staff or program management functions of organizations subject to audit. The head of the DoD internal audit organization shall be permitted to make an independent determination as to the nature and scope of audits to be performed and the contents of all audit reports. Moreover, determinations concerning merit pay, performance awards, or promotions for individual GS or GM audit personnel may not be controlled by officials from a staff or program management element subject to audit by the audit organization.

6. Coordination

a. DoD audit organizations shall coordinate and cooperate with each other and the General Accounting Office (GAO) in developing and carrying out approved audit plans. DoD audit organizations also shall coordinate and cooperate with other DoD investigation, inspection, and management groups to avoid duplication and to ensure effective oversight coverage of DoD programs and operations, as well as effective audit followup. DoD audit organizations shall provide appropriate audit support when such support is required by DoD investigative agencies. Audit techniques, training courses, guides, technical experts, and plans should be shared by DoD audit organizations. DoD-wide audit projects may be undertaken by the IG, DoD, as he or she determines appropriate. All audit assistence given within DoD Components for appropriated fund activities shall be performed on a nonreimbursable basis.

b. Normally, the DoD internal audit and internal review organizations will obtain information relative to contractors' records from DCAA. If DCAA is unable to provide the required assistance for audit services, the internal audit and the internal review organizations may review contractor records, as needed, to accomplish their assigned responsibilities. However, DoD internal audit and internal review organizations shall coordinate all reviews involving contractor records with the DCAA and the appropriate contract administration office to avoid duplication of audit work.

7. Audit Plans. Each audit organization shall prepare an annual audit plan in accordance with OMB Circular A-73 (reference (b)) and applicable DoD policies and procedures. Management needs shall be considered in the development of the audit plan. When completed, the annual audit plan shall be reviewed with the head or deputy head of the DoD Component, command, or activity that has operational control over the DoD audit organization in accordance with reference (b).

8. Prevention Activities. While DoD auditors shall be concerned with both the prevention and detection of fraud, waste, and abuse, the primary emphasis of DoD audit activities shall be in the area of prevention. The greatest benefit provided by DoD audit activities is the identification of opportunities to reduce the cost of DoD programs and operations, and to prevent the unnecessary or uneconomical expenditure of DoD funds. Effective internal control systems are critical to ensuring that DoD program objectives are achieved, and to lessening the opportunity for fraud, waste, and abuse in DoD programs and operations. The scope of DoD audits shall include an evaluation of internal control systems, and DoD audit organizations shall offer advice to management on whether internal controls in proposed programs or systems are adequate.

9. Fraud and Improper Conduct

a. Auditors shall be alert for situations of fraud and illegal acts. When auditors become aware that fraud or illegal acts may exist, such matters shall be coordinated promptly with the appropriate DoD investigative agency in accordance with applicable DoD policies and procedures. Moreover, if an auditor becomes aware of acts by DoD or contractor employees that involve significant noncompliance with DoD regulations or other improper conduct, these matters shall be reported immediately to appropriate senior DoD officials.

b. Employees of DoD audit organizations shall comply fully with the provisions of DoD Directive 5500.7 (reference (i)) and their DoD Components' implementing regulations.

10. Qualifications and Training. DoD audit organizations shall be organized and staffed so that professional audit services can be rendered to all levels of management. The DoD audit organizations shall possess or obtain the skills and knowledge to perform effectively their audit functions. Adequate training shall be provided to maintain and enhance the professional capabilities of the audit staff. The head of each DoD audit organization shall be a highly qualified professional audit manager and all audit personnel assigned to the audit organization in an audit supervisory or audit managerial capacity shall have a strong knowledge and indepth experience in auditing standards and practices.

11. Audit Reports

a. Audit results shall be reported promptly to be of maximum use. Interim reporting shall be used, if needed, to bring urgent matters to the attention of appropriate officials during the course of the audit. Recommendations shall be made to the lowest level that has the capability to take corrective action. Except in unusual circumstances, the audited activity shall be provided with a draft audit report and given an opportunity to present its views on the audit findings, recommendations, and potential monetary benefits. The views of the audited activity shall be made in writing. The final audit report shall present fairly the audited activity's position, together with the audit organization's position, on any nonconcurrences or nonresponsive comments.

b. Copies of internal audit reports and their summaries, prepared by the internal audit organizations and issued to DoD Component headquarters and major and intermediate commands, shall be distributed to the OIG, DoD. Copies of audit reports issued by the internal audit organizations to lower echelons shall be furnished to the OIG, DoD, in accordance with procedures prescribed by that office. Related audit working papers, documents, and files shall be made available to the OIG, DoD, upon request, for review by representatives of that office. All such material shall be controlled and safeguarded in accordance with applicable security policies, practices, and procedures.

c. Draft audit reports and other working papers normally will not be released to persons or organizations outside the Department of Defense. Upon request, final audit reports shall be provided by DoD audit organizations to DoD Components, other Federal agencies, the GAO, and the Congress, when required for the performance of Government functions. The public release of audit reports shall be handled in accordance with DoD Directive 5400.7 and DoD 5400.7-R (references (j) and (k)) and in accordance with DoD 5200.1-R (reference (l)) and Pub. L. 86-36 (reference (m)).

12. Audits for Other Federal Agencies and Governments. Contract and internal audits may be performed for other Federal agencies or foreign governments in accordance with existing agreements. These audits may not interfere unduly with performance of the required DoD audit responsibilities. Audit service for other Federal agencies and foreign governments shall be reimbursable at cost, except that the services may be provided for other Federal agencies without charge, if the work required is not extensive and can be performed within the existing capability of the DoD Component without additional costs.

13. Issuance of Inspector General Subpoenas. The IG, DoD, has the statutory authority to issue subpoenas for the production of all information, documents, reports, answers, records, accounts, papers, and other data and documentary evidence necessary in the performance of the functions assigned by the Inspector General Act of 1978 (reference (e)). The DoD audit organizations may request issuance of an IG subpoena in support of audits being conducted by them under procedures prescribed by the IG, DoD.

14. Limitations on Further Delegation of or Contracting for Audits

a. Unless otherwise prescribed by the IG, DoD, DoD Components may contract with independent public accountants, or delegate to other organizations at lower levels the responsibility for conducting audits of certain nonappropriated fund instrumentalities. The cognizant DoD internal audit organizations shall provide technical guidance and supervision and shall make reviews of audits performed by non-DoD audit organizations, to ensure compliance with existing audit standards as discussed in subsection F.4., above.

b. DoD Components may not contract with independent public accountants to perform internal audits, except as covered in paragraph F.14.a., above, or unless authorized under guidelines issued by the IG, DoD.

15. Access to Information

a. Auditors shall be granted full and unrestricted access to all personnel, facilities, records, reports, data bases, documents, or other DoD information or material that a properly cleared auditor requests as being necessary to accomplish an announced audit objective. All access granted or information or material furnished to the audit organizations will be on a nonreimbursable basis.

b. Only the head of a DoD Component may deny access to auditors under his or her authority. Such denials must be only for the reasons under which the Secretary of Defense could deny access to the IG, DoD (see Pub. L. 95-452, reference (e)). When an auditor other than an OIG, DoD, auditor is denied full and unrestricted access, the situation shall be reported through audit channels to the head of the DoD audit organization and through command channels to the head of the DoD Component within 15 workdays. The head of the DoD Component shall make a decision on the denial issue within 30 workdays from the time the auditor requested access. If the head of the DoD Component deems it appropriate to deny access, the head will so advise the IG, DoD, within 15 workdays of the final denial decision.

c. In addition to the provisions of paragraph F.15.a. above, guidance on access to records and information by OIG, DoD, auditors is provided by DoD Instruction 7050.3 (reference (n)).

G. EFFECTIVE DATE AND IMPLEMENTATION

This Directive is effective immediately. Forward one copy of implementing documents to the Inspector General, Department of Defense, within 120 days.

William H. Taft, IV
Deputy Secretary of Defense

Enclosure - 1
References

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REFERENCES (continued)

(e) Public Law 95-452, "Inspector General Act of 1978," as amended, October 12, 1978 (5 U.S.C., Appendix III)
(f) DoD Directive 5105.36, "Defense Contract Audit Agency," June 8, 1978
(g) DoD Directive 7650.3, "Followup on General Accounting Office, Internal Audit, and Internal Review Reports," June 23, 1983
(h) DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," December 29, 1982
(i) DoD Directive 5500.7, "Standards of Conduct," January 15, 1977
(j) DoD Directive 5400.7, "DoD Freedom of Information Act Program," March 24, 1980
(k) DoD 5400.7-R, "DoD Freedom of Information Act Program," December 1980, authorized by reference (j)
(l) DoD 5200.1-R, "Information Security Program Regulation," August 1982, authorized by DoD Directive 5200.1, June 7, 1982
(m) Public Law 86-36, "National Security Agency Act--Officers and Employees"
(n) DoD Instruction 7050.3, "Access to Records and Information by the Inspector General, Department of Defense," November 9, 1984

ENCLOSURE 5

DEPARTMENT OF DEFENSE
INSPECTOR GENERAL
WASHINGTON, D.C. 20301

21 DEC 1983

MEMORANDUM FOR SECRETARY OF THE ARMY
SECRETARY OF THE NAVY
SECRETARY OF THE AIR FORCE
ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)
ASSISTANT INSPECTOR GENERAL FOR AUDITING, OIG, DOD

SUBJECT: Contract Audit Policy Memorandum Number 1 - Relationships Between Contract and Internal Audit Organizations

REFERENCES: (a) DoD Directive 5106.1, "Inspector General of the Department of Defense," March 14, 1983

(b) DoD Directive 5105.36, "Defense Contract Audit Agency," June 8, 1978

(c) DoD Directive 7600.2, "Audit Policies," August 7, 1978

(d) DoD Instruction 7600.3, "Internal Audit in Department of Defense," January 4, 1975

A. PURPOSE

This memorandum is issued pursuant to paragraph G.1 of reference (a) and provides interim guidance pending revision to references (c) and (d). The memorandum expands on existing policies and provides more definitive procedures for requesting audit assistance by contract or internal audit organizations in connection with their reviews of DoD procurement operations and audits relating to programs and operations of the Department of Defense. In addition, it provides guidance on the Defense Contract Audit Agency (DCAA) relationships with the Inspector General, DoD; internal audit; internal review; and other similar organizations.

B. APPLICABILITY

The provisions of this memorandum apply to all DoD components authorized to have a contract or internal audit

organization. The provisions also apply to the audit organizations of the military exchange systems and the internal review activities of DoD.

C. BACKGROUND

The Inspector General, DoD audit mission, authority, and responsibility are enumerated in reference (a). As part of the responsibility for conducting audits relating to the DoD programs and operations, the Inspector General, DoD shall perform audits of DoD procurement and contracting functions.

The DCAA mission, as set forth in reference (b), is to provide accounting and financial advisory services regarding contracts and subcontracts to all DoD components responsible for procurment and contract administration. The advisory role of the DCAA auditor is set forth in reference (c). Reference (d) provides that the contract auditor may provide assistance to the internal auditor under certain circumstances; reference (a) gives the Inspector General, DoD the authority to request assistance as needed from other audit, inspection and investigative units of DoD components.

D. POLICY

1. General. This memorandum expands upon and clarifies existing policies in the relations between DCAA and internal audit organizations and the Inspector General, DoD. The Government's interest will be served by full cooperation and exchange of information with the Inspector General, DoD and between other contract and internal audit organizations. This will ensure the efficient use of our limited audit resources.

2. Areas of Responsibility

a. Inspector General, DoD. The Inspector General, DoD and the internal audit organizations are responsible for, among other things, auditing the procurement function within DoD. That responsibility includes both the internal audit of the DoD management of the procurement function and the review of contracts and contractors as they affect the procurement function. They have a key oversight role in evaluating the efficiency and effectiveness with which procurement and contract administration functions are managed by their respective Services. In performing these functions, the audit organizations may require DCAA to provide fact-finding assistance.

b. Defense Contract Audit Agency. Defense Contract Audit Agency has the responsibility of providing contract audit service for the DoD components which perform procurement and contract administrative functions. This assistance is usually advisory in nature. Also, DCAA provides audit assistance on request for the review and evaluation of procurement and contract administrative functions within DoD. This assistance will be on a non-reimbursable basis and is usually fact-finding in nature.

3. Audit Assistance

a. Planning a Request for Contract Audit Assistance. Defense Contract Audit Agency should be provided copies of internal audit annual program plans when significant contract audit assistance is anticipated. Careful consideration should be given to the requirement for assist contract audit service at the contractor's site. Arrangements will be made with DCAA when internal audit requirements have been defined. To expedite the process, preliminary telephone contact is encouraged between the requesting audit organization and the related DCAA office(s) followed up by a written request. Sufficient time should be allowed to coordinate the audit request and schedule the work. Any organizational level of DoD audit organizations can request such assistance.

b. Preparing a Request for Contract Audit Assistance. Requests for DCAA audit assistance will be submitted in writing to the appropriate DCAA organizational level to avoid any misunderstandings. The request should provide enough information so that the DCAA auditor will fully understand the purpose, scope, and objective of the audit area. This will enable the DCAA auditor to determine the audit effort required.

c. Responding to Requests for Contract Audit Assistance. Defense Contract Audit Agency will confirm all requests in writing. If DCAA cannot perform all of the assist work, the confirmation should specifically state what portion(s) can not be performed and the reasons therefore. If DCAA refuses requests for audit assistance without adequate justification, it will be the requester's responsibility to provide applicable correspondence to the Assistant Inspector General for Audit Policy and Oversight, Office of the Inspector General (OIG), DoD for further action. All related requests, confirmations and reports will be selectively monitored by the Inspector General, DoD office.

d. When Contract Audit Assistance Can Not Be or Is Not Provided. In certain situations, the circumstances or the nature of the information required, may make it impractical or inappropriate for the DCAA auditor to comply with the request for audit assistance. In these cases alternative arrangements must be considered. These gound rules apply:

(1) Internal auditors are not precluded from reviewing contractors' books and records under the following circumstances:

(a) When the information required would place DCAA in a position of reviewing, analyzing, or reporting on procurement personnel which might hamper its relationships with the Procurement Contracting Office (PCO) or Administrative Contracting Office (ACO).

(b) When DCAA is unable to render such assistance in a timely manner because of other priorities, it will notify the requesting audit organizations and DCAA will be responsible for making the necessary administrative arrangements for access to those records needed to complete the internal audit.

(2) Internal auditors will have complete access to DCAA contract audit working papers, reports and files to the maximum practicable extent for their use in audits of DoD procurement, contract administration, or related functions.

4. Internal Audit Organization Assistance to Defense Contract Audit Agency. Although the policy guidance deals with internal audit organizations requests for DCAA services, it also provides for DCAA to request assistance from the internal audit organizations as needed. Internal audit assistance may be required in those instances when contract audits involve work at a Defense installation or remote location where the nature of the work, proximity of an internal audit office, or other factors make it more practical or economical for the contract auditor to obtain assistance from an internal auditor. Requests for audit assistance from Army internal review elements by DCAA should be addressed to the appropriate Army commander.

5. Resolving Contract Audit Assistance Problems. If audit interface problems develop between local or regional DCAA offices and internal audit offices at these locations, the contract/internal audit organization(s) should notify the appropriate office in their headquarters and explain the problem, provide pertinent facts, and recommend a course of

action to resolve the matter. If the circumstances warrant, designated staff member(s) should meet to resolve the problem. Efforts should always be made to resolve interface problems at the lowest level. In the event an interface problem cannot be resolved, the matter (fully documented) will be referred by the requesting organization to the Assistant Inspector General for Audit Policy and Oversight, OIG, DoD for further action and resolution.

6. Inspector General, DoD Request for Assistance. The Inspector General, DoD may request assistance, as needed, from other audit, inspection, and investigative units of DoD components. In such cases, assistance shall be requested through the head of the DoD component concerned. The Inspector General, DoD has access to all records, reports, investigations, audits, reviews, documents, papers, recommendations, or other material available to any DoD component. Audit assistance problems will be handled on a case-by-case basis pending development of standard procedures.

7. Access to Records. If the PCO or ACO deny either DCAA or the internal audit organizations access to contractor records, the requesting agency will document the matter and refer the problem to the Assistant Inspector General for Audit Policy and Oversight, OIG, DoD for further action and resolution.

8. Exchange of Information. Each audit organization should have access to each other's material. There should be a direct interchange of copies of audit reports, programs, instructions and other material related to audit methods and techniques. The internal audit organizations will provide DCAA a copy of their final report which incorporates the contract audit assistance. Other reports should be provided on a request basis. Defense Contract Audit Agency will honor request for reports relating to areas of procurement and contract administrative matters and will provide the copies directly to the Inspector General, DoD or audit organizations. These include reports on estimating systems, purchasing systems, property management systems, operational audits, etc.

E. ACTION REQUESTED

Defense Contract Audit Agency and the internal audit organizations will comply with the policies set forth herein, and will provide additional guidance to ensure effective implementation of this policy memorandum.

F. EFFECTIVE DATE

This Contract Audit Policy Memorandum is effective for two years from its date of issue or until incorporated into a DoD directive or instruction.

Joseph H. Sherick
Inspector General

STATEMENT OF
AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.
CONCERNING AUDITS
SUBMITTED TO
SUBCOMMITTEE ON DEFENSE ACQUISITION POLICY
COMMITTEE ON ARMED SERVICES
UNITED STATES SENATE

March 1985

The Aerospace Industries Association of America, Inc. (AIA), the trade association representing the nation's major manufacturers of commercial, military and business aircraft, helicopters, aircraft engines, missiles, spacecraft and related components and equipment, appreciates the opportunity to submit this statement for the record of the Subcommittee's hearing.

We fully recognize the interest that Congress has in ensuring that procurement dollars are wisely spent, particularly in these times of rising defense budgets and huge budget deficits. We all have a responsibility to guard against fraud, waste or any abuses which detract from the goal of getting the most for the taxpayers' dollars.

It is not our intention to urge deferral or relaxation of appropriate contractor oversight by auditors, nor do we intend to imply that either Congress or the Executive Branch should abdicate its role and responsibility in safeguarding the taxpayers' interests. What we wish to point out, however, is that some of the audit and oversight functions are duplicative and/or

excessive. Whenever this occurs, it is not only a waste of the scarce government resources available to perform these oversight functions, but also ties up contractor resources for long periods of time and is thus counterproductive.

To cite first some examples where duplication and/or excessive review do occur:

- Both the Defense Contract Audit Agency (DCAA) and contract administration activities (Defense Contract Administration Services, Air Force Contract Management Division, and others) perform operational type audits or reviews of such areas as productivity, subcontract management, and scrap, rework and repair.
- Both the General Accounting Office (GAO) and the Executive Branch activities perform pricing surveys and program status reviews. In addition, the GAO performs compensation reviews.
- Compensation reviews are performed by DCAA, contract administration activities (e.g., DCAS), GAO, and the Department of Defense Inspector General.
- Both the Air Force Contract Management Division (AFCMD) and the resident Air Force Plant Representative Office (AFPRO) perform Contractor Operation Reviews, covering the same areas.
- Forward Pricing Rate Reviews are conducted by both the contract administration organizations and by DCAA.
- Detailed program audits are conducted even though a contractors' management system has been previously validated as being in full compliance with the Cost/Schedule Control System criteria of DOD Directive 7000.2.

- Should-Cost reviews, proposal fact finding, and management control system reviews, heightened by the recent emphasis on fraud, are often redundant, and lead to excessive and repetitive demands for access to records. Proposal fact-finding consists of detailed reviews of all master proposals. This activity is conducted by DOD program office personnel in combination with representatives from other government audit groups for the purpose of gathering data from which to formulate contract negotiation strategy and objectives. Should-Cost activity includes a family of detailed program audits conducted by program office personnel in conjunction with representatives of various government audit groups. The purpose of this activity is to evaluate the contractor's organization and method of operation for the purpose of identifying areas of inefficiency and other sources of potential program cost problems. The results of Should-Cost activity are often combined with the results of fact-finding activity in the formulation of government negotiation strategy and objectives.

The following are some examples of how a few of these audits and reviews have burdened a representative company.

- Contract Management System Evaluation Program (CMSEP) and Contract Operations Review (COR)

  The COR is an in-depth, two-week review by a 40 member team of representatives from the various Air Force Plant Representative Office (AFPRO) detachments around the country. It is redundant

because an AFPRO detachment in residence at the company carries out a continuing review under the CMSEP, which covers all the areas that the COR team is examining in its special review.

oSubsequent Application Reviews (SAR's)

SAR's consist of very detailed program audits of all contracts requiring compliance with DOD Directive 7000.2, Criteria for Cost/Schedule Control Systems (C/SCS). The company has a C/SCS system which has been validated to be in full compliance with the DOD Directive 7000.2 criteria. SAR's are conducted for the sole purpose of verifying that the company management control system is properly implemented on all appropriate contracts. In view of the prior validation, this is duplicative and serves no useful purpose.

oSubcontract Management Review

DCAA planned to conduct a "Subcontract Management" review at the same time the "Productivity" and COR reviews were in progress. This review has been postponed, but it will be the fifth time such a review has been conducted at this firm. Previous reviews were conducted in May 1981, March 1982, September 1983, and July 1984.

oProductivity Review

DCAA is conducting a review of "Contractor Initiatives to Increase Productivity." The nature of the "Productivity" review is such that it requires participation by the same contractor personnel who are devoting almost 100% of their time and effort to supporting the COR -- which was scheduled months prior to the "Productivity" review. Requests for postponement of the latter review until after COR were denied. The review is now in progress, and requires the same resources to be applied to both projects, concurrently.

oScrap, Rework and Repair Review

The AFPRO initiated a "Scrap and Rework" review in September 1982. The review was completed in July 1983 with a final report in November 1983. A series of meetings, work sessions, and discussions ensued between the company and AFPRO in 1984. The company's detailed responses to the final report were held in abeyance with the concurrence of AFPRO. During this time, DCAA initiated its own review of "Scrap and Rework" (August 1984). Efforts to inform DCAA that AFPRO still had an "open" review in this area resulted only in a statement that DCAA "would not look at the same things AFPRO looked at." The DCAA review was completed in January 1985. The company's final response to the AFPRO review was submitted in November 1984.

The government's policies covering the various oversight activities are not intended to cause either duplication or excessiveness. However, the fact remains that it does occur. What is needed is closer coordination by the review activities and a determined effort to minimize disruption of contractor operations without impacting on the effectiveness of oversight functions, whether they be contract audits, management reviews, purchasing system reviews, productivity audits, or others.

We have four recommendations which will ease the adverse impact of these reviews and audits, while simultaneously providing adequate oversight to the responsible agencies.

First, there should be an annual coordinated audit and review plan agreed to by the DCAA, DOD IG and the contract administration activity (whether it be an AFPRO, NAVPRO or DCAS element), and any other interested government agencies.

Second, a lead agency concept should be applied and enforced. This would eliminate many of the duplicative reviews and audits, both management-type and on particular cost issues, which often result in uncoordinated and contradictory findings.

Third, the contracting officer should be given clear authority to resolve conflicts in scheduling and to enforce the role of the lead executive agency concept in his role as the government's agent. (DCAS has been designated as the executive agent for conducting compensation reviews at contractor locations. However, DCAA has conducted its own compensation audits at the same contractor locations.)

Fourth, the GAO should endeavor to use data gathered by other government agencies prior to initiating its own reviews.

That concludes the statement of the Aerospace Industries Association.

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MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

May 6, 1985

The Honorable Dan Quayle
Chairman, Subcommittee on Defense
Acquisition Policy
Committee on Armed Services
United States Senate
Washington, D.C. 20510

Defense Contract Audits

Dear Chairman Quayle:

In connection with the hearings your subcommittee has been conducting in recent months on defense acquisition policy, we wish to bring to your attention the views of the Machinery and Allied Products Institute (MAPI) on certain defense contract audit practices which, in our view, are inconsistent with the law and sound public policy. While these audit practices are intended to reduce contractor costs, they in fact stifle creativity and cause inefficiencies in the acquisition process and thereby increase contractor costs.

MAPI represents the capital goods and allied products industries of the United States. In addition to traditional capital goods product lines, MAPI's constituency includes leading companies in the electronics, precision instruments, telecommunications, computer, office systems, aerospace, and similar high-technology industries. Although many of the companies in these industries are predominantly oriented towards the commercial market, many have substantial defense sales and, accordingly, have a vital interest in defense contract audit policy.

Scope of MAPI Comments

We wish to express our objections, based on legal and public policy considerations, to three defense contract audit practices relating to government access to contractor internal management records (internal reports, planning and decision documents, and working papers). The first involves the Defense Contract Audit Agency's (DCAA's) policy of demanding access to internal management records. Allowing DCAA to have access to

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATIONS, DEDICATED TO THE PRESERVATION, ADVANCEMENT AND EMPLOYMENT OF TECHNOLOGY IN THE ECONOMICS OF CAPITAL GOODS THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND ENGINEERING IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

internal management records, which are considered by contractors to be confidential management tools, is neither consistent with good public policy nor supported by relevant statutes, regulations, or case law. Furthermore, access to internal management records is not necessary for DCAA to perform an audit of government contract costs (incurred or anticipated).

If DCAA is not entitled to audit access to internal management records, it then follows that it is neither good public policy nor legal for the Department of Defense Inspector General (DOD IG) to use his subpoena power to enforce what DCAA perceives as its right of access to internal management records. It is also inconsistent with the Inspector General Act of 1978 and public policy for the DOD IG to issue a subpoena, in connection with IG activities as distinguished from DCAA audits, for internal management records.

In the detailed statement of our position which follows, we elaborate on these three defense contract audit practices. In addition, we suggest some more effective ways to reduce contractor costs.

The DCAA Practice of Demanding Access to Internal Management Records

DCAA is aggressively pursuing, in the face of contractor opposition, access to a variety of internal management records, including motivational budgets, individual fitness reports, minutes of board meetings, and internal audit reports. In some cases in which contractors have not voluntarily submitted to an operational audit and provided DCAA with access to internal management records, DCAA has imposed a panoply of sanctions, including immediately suspending and/or disapproving costs and recommending the same to contracting officers with respect to progress payments. As a further example, DCAA has obtained the assistance of the DOD IG to subpoena internal audit reports from Westinghouse Electric Corporation. Westinghouse's refusal to comply with the subpoena has resulted in litigation before the Armed Services Board of Contract Appeals (ASBCA)/1 and a federal district court./2

DCAA asserts that it must review internal management records to determine the reasonableness and allocability of the costs of the organizational units generating the records and to perform its operational audit function. As indicated in paragraph 5-102(b) of the DCAA Contract Audit Manual (CAM), operational audits are designed to evaluate the management functions of a contractor:

> The review of management decisions includes the performance of operational auditing. In operational auditing, an evaluation is made to determine whether the entity is managing or utilizing its resources, personnel, property, space, etc.,

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1/ Appeal of Westinghouse Electric Corporation, ASBCA No. 30595 (filed January 9, 1985).

2/ U.S. v. Westinghouse Electric Corporation, Misc. No. 11710 (W.D. Pa., filed December 27, 1984).

> is an economical and efficient manner, and the causes of any inefficiencies or uneconomical practices are identified. The basic purpose of operational auditing is to assure the existence of adequate controls which will prevent or avoid wasteful, careless, and inefficient practices by contractors. Guidance with respect to the use of this technique, or audit approach, is in other paragraphs of this manual as it relates to specific applications.

These two alleged legal bases for access to internal management records, along with relevant public policy considerations, are discussed below.

Access To Determine Reasonableness and Allocability of Costs

While it may be argued with some merit that a review of the various internal management records to which DCAA is seeking access would assist somewhat in evaluating the reasonableness and allocability of the costs of the organizational units which generated the records, this is outweighed by the fact that the claim of DCAA to the right of audit access to such records is both inconsistent with the case law and inappropriate.

Legal considerations.—If DCAA were to be granted the right of access to any one type of internal management record to determine the reasonableness and allocability of the costs incurred by the organizational unit generating the particular type of record, DCAA logically would have a right of access to all internal management records where any portion of the costs for generating such records is allocated to government contracts. By the same token, DCAA would have access to almost all internal management records because some portion of the costs of almost all internal management records is allocated to at least one government contract. This is because the generation of internal management records involves indirect costs which are allocated to individual contracts performed by the contractor in accordance with generally accepted accounting principles, practices and standards issued by the Cost Accounting Standards Board, and applicable contract cost limitations and exclusions. Further, since the costs of generating internal management records for both commercial and government contracts are combined in an indirect cost pool and then allocated to individual contracts, DCAA's position would even allow access to documents which pertain wholly to commercial business divisions of the contractor. In brief, DCAA could claim a right to obtain almost every report, planning and decision document, and working paper a company prepares.

Such a result would be inconsistent with the case law, the statutes, and the contract audit clauses found in the Federal Acquisition Regulation (FAR). The audit clauses are found at FAR 52.215-2, "Audit-Negotiation" clause, and FAR 52.214-26, "Audit-Sealed Bidding" clause. The "Examination of costs" and "Cost or pricing data" provisions of the FAR audit clauses permit DCAA access to only those records which reflect costs, and access to such cost records is limited to those cost records which are sufficient or necessary to perform an audit of contractor costs. The "Examination of costs" provision gives the government the right to audit and examine only those records "sufficient to reflect properly all costs

claimed to have been incurred or anticipated to be incurred in performing [the] contract." (Emphasis added.) The "Cost or pricing data" provision similarly limits the government's access to records "related to negotiating, pricing, or performing the contract or modification, in order to evaluate the accuracy, completeness, and currency of the cost or pricing data. The right of examination shall extend to all documents necessary to permit adequate evaluation of the cost or pricing data submitted . . . ." (Emphasis added.)

The "Examination of costs" and "Cost or pricing data" provisions are consistent with the statutes they implement, 10 U.S.C. 2313(a) and 10 U.S.C. 2306(f), respectively. Both statutes provide that the government is authorized access to only records which reflect costs.

Such broad access would also be inconsistent with case law. In Grumman Aircraft Engineering Corp., 66-2 BCA 15846 (1966), p. 27,143, the Armed Services Board of Contract Appeals stated that the government ". . . auditor certainly has no right to roam without restriction through all the contractor's business documents which have no connection with the Government contract. . . ."

With respect to internal audit reports, DCAA claims that several cases, including Grumman, support its right of access to verify the reasonableness and allocability of the costs associated with the internal audit department. The cases do not support DCAA's alleged right of access to internal audit reports or any other internal management reports. Rather, they simply hold that DCAA can examine source documents and original cost entries to establish an "audit trail." That is, DCAA is authorized to perform a cost-based audit by examining records which reflect the costs (incurred or anticipated) by the contractor. Therefore, the cases no more authorize DCAA access to internal audit reports or any other internal management records than do the audit clauses or statutes.

Internal management records, such as internal audit reports, are not source documents or original cost entries, but confidential management tools. If, in the preparation of an internal management record, source documents or original cost entries were examined, those documents are available to DCAA where they relate directly to the company's government contracts. Similarly, the costs of the organizational unit which generated an internal management record are systematically recorded and made available to DCAA.

Public policy considerations.--Not only is there no legal basis for allowing DCAA access to internal management records to determine reasonableness and allocability of costs, but also such access should be precluded as a matter of public policy. While DCAA's practice of demanding access to internal management records is apparently directed at reducing contractor costs (and thereby government costs), the practice is counterproductive because it is not cost-effective. Further, the audit practice constitutes an unwarranted intrusion into the privacy of contractors. These two public policy reasons for not permitting DCAA access to internal management records are discussed below.

It is not cost-effective for the government to examine internal management records for the purpose of determining the allocability and reasonableness of

the costs of the organizational units which generated the records. The costs incurred by the government and the defense contractors for the audit of a multitude of records which have no direct relevance to government contract costs cannot be justified: In return for a major audit effort, the government most often will receive only de minimus additional assurance that contractors have charged costs correctly.

While a review of internal management records may provide a little additional assurance that the costs of the organizational units which generated the records are reasonable, it is a patent waste of effort to review many such records to determine the allocability of those costs to government contracts. This can be illustrated by reference to internal audit reports. A contractor's internal auditors do not audit particular government contracts, but audit management functions which not only span various government contracts, but also commercial contracts. Therefore, in accordance with generally accepted accounting principles, and the standards issued by the Cost Accounting Standards Board, the costs of the internal audit department are viewed as indirect costs which are allocated to all contracts--government and commercial. It is the reasonableness of the contractor's method of allocating indirect costs, not the audit reports themselves, which indicate whether the costs of the internal audit department have been properly allocated to government contracts.

On the other hand, the records reflecting the costs of the internal audit department and other organizational units which generate internal management records are all that is necessary and authorized by law to determine the reasonableness and allocability of the costs associated with those organizational units. Those cost records are readily made available to DCAA.

Not only does the government incur wasted costs in examining internal management records when the original source documents are available, but also the contractor incurs unnecessary costs. Whenever a government audit is conducted, contractor personnel brief the auditors, obtain records for them, and accompany them through the contractor's plants. It is the experience of some contractors that, as soon as one group of auditors has left, an audit group from another government agency arrives to examine, as often as not, the same records. Any costs incurred by contractors attributable to government audits is really a cost to the government because the government is eventually charged for those costs.

It is an intrusion into contractors' private business affairs for DCAA to have access to internal management records. The invasion of privacy is particularly egregious because the contractors consider the internal management records to be confidential. Moreover, DCAA is demanding access--in the case of internal audit reports--to all internal management records. Yet many of the records pertain partly or wholly to commercial contracts.

This intrusion into contractors' private business affairs is totally unwarranted because access to internal management records is not necessary for DCAA to perform its audit function. Further, such access is counterproductive with respect to cost reduction.

Access to Internal Management Records Through Operational Audits

Legal considerations.--There is no basis in the relevant statutes, case law, or the audit clauses for DCAA to perform unlimited operational audits of contractors' management functions to evaluate the efficiency of their operations. It is implicit in the audit clauses that DCAA may perform an operational audit for the limited purpose of evaluating the reliability of contractor cost accounting systems. Contractors generally recognize that DCAA has a right to examine cost management and recordkeeping systems to ensure that costs are properly recorded and allow DCAA access to such records.

Regardless of whether DCAA is conducting a cost-based audit or an operational audit, government access to records is limited by the statutes and audit clauses. The statutes and audit clauses permit access only to records reflecting costs (with the limited exception noted above) and not to internal management records. Therefore, operational audits can be conducted only at the sufferance of contractors.

Public policy considerations.--As a matter of public policy, DCAA should not be permitted access to internal management records for the purpose of performing operational audits. Operational audits result in over-regulation of contractors--that is, the government assumes the contractors' management role. Also, the audit practice is not cost-effective.

Through DCAA operational audits, with their concomitant review of internal management records, the government is assuming a management role with respect to defense contractors. This is, of course, inconsistent with our notions of private enterprise. For over 30 years, Office of Management and Budget (OMB) Circular A-76 has stressed reliance on the private sector to meet government needs. OMB Circular A-76 is predicated on the belief that private industry is more efficient because of the profit incentive. In the case of defense contractors, however, the government is trying to increase contractor efficiency by managing the companies rather than harnessing the profit incentive through increased competition and other means.

The government's attempts to increase efficiency through regulation stifle initiative and undermine the effectiveness of many internal management controls. As stated before your subcommittee on January 30, 1985 by Thomas G. Pownall, Chairman and Chief Executive Officer of Martin Marietta Corporation, the United States leads the world in technology and the performance capabilities of its weapon systems because the government procurement system encourages ingenuity and innovative thought. Mr. Pownall cautioned Congress that over-regulation and over-control can stifle the initiatives and incentives that have successfully driven the procurement process.

Over-regulation stifles initiative because management will be hesitant to take chances if the government is second-guessing management decisions. Management will be reluctant to deviate from the mode of operations recommended as a result of an operational audit. Management may be reluctant to take chances due

to the fear that, if a decision does not work out, the government may disallow costs because the decision may be viewed by the government, using hindsight, to have been a poor one.

Over-regulation also undermines the effectiveness of many internal management controls because much of their effectiveness is based on the confidentiality of management records. For example, it is inappropriate for DCAA to examine internal audit reports because such disclosure outside the company would seriously undermine the internal audit function. An auditor would tend to be less candid and critical and more reserved in expressing opinions if he knew his reports were to be made available outside the company.

Because of the adverse impact that DCAA's access to internal management records has on management initiative and internal management controls, the audit practice is counterproductive. That is, the audit practice is not cost-effective because it decreases efficiency and thereby increases costs.

The DOD IG's Practice of Subpoenaing Internal Management Records on Behalf of DCAA

The Inspector General Act of 1978 (IG Act) (P.L. 95-452)/1 provides each IG with the power to subpoena records "necessary" to perform his functions related to the "programs and operations" of his agency. Sections 6(a)(4) and 4(a)(1) of the IG Act delineate the above limitations on the IG's subpoena power. Section 6(a)(4) authorizes an IG—

> . . . to require by subpena the production of all information, documents, reports, answers, records, accounts, papers, and other data and documentary evidence necessary in the performance of the functions assigned by this Act . . . .

Section 4(a)(1) explains what the "functions" of the IG are. Specifically, Section 4(a)(1) gives each IG the duty and responsibility—

> . . . to provide policy direction for and to conduct, supervise, and coordinate audits and investigations relating to the programs and operations of [his agency.]

Because procurement is a "program or operation" of the Defense Department, the DOD IG presumably has the power to subpoena those contractor records which are "necessary" for him to perform his "functions" related to procurement. Further, because DCAA audits procurement contracts, the DOD IG would have oversight responsibility for DCAA. However, nothing in the IG Act indicates that the IG's subpoena power extends to obtaining records on behalf of another agency for which the DOD IG has oversight responsibilities.

1/ P.L. 95-452 (5 U.S.C. app. §1, et. seq. (1982)) was amended by P.L. 97-252 in 1982 to establish an Office of Inspector General in DOD.

Moreover, the legislative history of the IG Act clearly indicates that an IG may not use his subpoena power on behalf of another agency which does not have subpoena power. Senate Report No. 95-1071 states that—/1

> The committee intends, of course, that the Inspector and Auditor General will use this subpoena power in the performance of his statutory functions. The use of subpena power to obtain information for another agency component which does not have such power would clearly be improper. [Footnote omitted.]

Since DCAA is a separate agency component of DOD, it is apparent that Congress did not intend for the DOD IG to use his subpoena power on behalf of DCAA.

The DOD IG's Practice of Subpoenaing Internal Management Records on His Own Behalf

Even if the DOD IG were to issue a subpoena on his own behalf for internal management records as part of an oversight review of DCAA's access to records,/2 the subpoena would not be valid. This is because, as previously shown, DCAA itself has no legal basis for access to internal management records. Therefore, a DOD IG review of DCAA's access to contractor records would not extend to internal management records. Accordingly, the DOD IG would have no legal basis, as part of a review of DCAA's access to contractor records, to subpoena internal management records.

A DOD IG subpoena would also be invalid if it were issued in connection with the DOD IG's own audit or investigation because the DOD IG is not statutorily authorized to conduct a general oversight review of contractor internal management functions. Congress did not expressly grant such authority in the IG Act, and there are no grounds to believe that it intended the DOD IG to have unlimited access to the internal management records of defense contractors.

In fact, the IG Act conveys the contrary intention of limiting the DOD IG's access to those records that are "necessary" for the DOD IG to perform an audit or investigation related to DOD "programs and operations." In the case of a contract audit, the "necessary" records would be cost records. In an investigation, the "necessary" records also would be the contractor' cost records except to the extent the DOD IG could identify another type of document or limited class of documents as being "necessary" for his investigation.

Although the DOD IG is generally entitled to no internal management records, he has, in response to DCAA's request, subpoenaed all the contractor internal audit reports in the Westinghouse case now in litigation, including those

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1/ 4 U.S. Code Cong. & Ad. News (1978), p. 2709.

2/ On March 9, 1984, the office of the DOD IG completed a review of DCAA's access to records and issued a report entitled "Report on Oversight Review of the Access to Records by Defense Contract Audit Agency."

pertaining wholly to commercial contracts. The subpoena does not indicate the relevance of any of the internal audit reports to any particular investigation or audit, but simply states that the DOD IG has the authority, with respect to DOD "programs and operations," to conduct and supervise audits and to investigate fraud, waste, and abuse. That, of course, is merely a recitation of his statutory functions and would appear to indicate that the DOD IG believes he has carte blanche access to all records of a contractor for whatever reason (or even no apparent reason) and whenever he chooses. We do not believe that such use of the subpoena power by the DOD IG comports with the literal words of the IG Act or with Congress' intent.

The same public policy reasons that weigh heavily against DCAA performing operational audits militate against the DOD IG conducting oversight reviews. DOD oversight reviews, just as in the case of DCAA operational audits, result in over-regulation of the contractor and an unwarranted intrusion into a contractor's private business affairs. Further, it is not cost-effective to perform oversight reviews because, as in the case of operational audits, the DOD IG's access to internal management records would have an adverse impact on management initiative and internal management controls.

Other Methods for Reducing Contractor Costs

The best way to reduce contractor costs in the defense acquisition process is to minimize regulation and to maximize the natural market incentives to decrease costs. The over-regulation of the defense industry and the lack of incentives within DOD and the defense industry to reduce costs is addressed in a February 1985 report published by The Center for Strategic and International Studies (CSIS) of Georgetown University, Washington, D.C. Although MAFI does not necessarily endorse the report in full, we certainly think its comments in the procurement area deserve careful consideration. The report, which is entitled "Toward a More Effective Defense: The Final Report of the CSIS Defense Organization Project," discusses five reasons why there is a lack of natural market incentives to reduce costs in the defense industry. Two reasons, which are discussed on page 50 of the report, are particularly relevant to the cost-effectiveness of the audit practices which are the subject of this letter:

> In spite of the fact that defense is not normally considered a regulated industry, it is important to recognize the very high degree of regulation present. Moreover, this regulation is unique in that the regulator is also the dominant buyer. With so much involvement on the part of the buyer in the operation of the supplier, it is difficult for the free market to operate. Nevertheless, there is a strong tendency within the department, the Congress, and the defense industry to act as if free market conditions exist and rely on the invisible hand of the market to produce economic efficiency.
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> Perhaps the dominant characteristic of the weapon acquisition process is the lack of competition for most of the dollars involved. When the Department of Defense initiates

competitive bidding for the development of a new generation of a weapon system, there is usually fierce rivalry among several large firms. But once the selection for initial development is complete, the rest of the program--product development, testing and eventual production--is normally conducted in a sole-source environment. Thus, unlike the commercial marketplace, the buyer--the government--has no alternative sellers or competing products to meet its need. Essentially, the contractor has achieved a monopoly position. The Department of Defense is dependent on that producer for crucial equipment and thus lacks leverage in setting the terms of subsequent contracts. This distinction between competition for an initial award and the lack of competition during the execution of a program is the primary difference between the defense market and the commercial world.

Besides this lack of a continuous alternative, the normal profit incentive for cost reduction is minimized in defense contracting. Under the current system, the department typically negotiates annual production contracts based upon the previous year's costs plus a profit margin that remains relatively constant. Accordingly, the contractor is often rewarded when costs rise, since the profit of the follow-on contract is computed on a larger cost base. With such incentives, there is little pressure to hold down future labor and material costs because the contractor can usually pass these costs directly on to the department.

As indicated above, the government has, through regulation, reduced the competition and profit incentives for cost reduction. The result of this over-regulation is higher contractor costs, yet DOD's solution for reducing contractor costs is more regulation through audit practices of dubious value and legality.

A better solution to the problem of rising contractor costs is to create the competition and profit incentives to reduce costs. Promoting competition and allowing contractors to increase profit margins when costs fall are more effective means for the government to reduce contractor costs.

Conclusion

We believe, as we have discussed above, that there are many legal and public policy reasons why DCAA and the DOD IG should not be granted access to contractor internal management records. These legal and policy reasons can be summarized as follows:

1. DCAA is not authorized by statute, case law, or regulation to have access to internal management records for the purpose of determining the reasonableness and allocability of the costs of the organizational units which generated the records. DCAA is permitted by law to have access only to those records which

reflect costs of performing the contracts, and access to such cost records is limited to those cost records which are necessary to perform an audit of contractor costs. Internal management records are not cost records. Even if such records include some cost data because they are based in whole or part on cost records (source documents and original cost entries), it is not necessary for DCAA to examine the internal management records in order to properly conduct an audit of contractor costs because the source documents and original cost records are available.

2. DCAA is not entitled to access to internal management records while performing an operational audit because DCAA is not authorized by statute, case law, or regulation to perform operational audits except for the limited purpose of evaluating contractor cost accounting systems to determine whether costs are accurately recorded.

3. The legislative history of the Inspector General Act of 1978 makes it clear that an IG may not use his subpoena power on behalf of another agency. Therefore, the DOD IG may not subpoena internal management records on behalf of DCAA.

4. Moreover, the DOD IG cannot use his subpoena power to obtain for DCAA records which DCAA cannot directly obtain. The DOD IG is not authorized to subpoena internal management records on his own behalf as part of an oversight review of DCAA's access to records because DCAA is not legally entitled to them in the first place. Inasmuch as the DOD IG is not permitted by the Inspector General Act of 1978 to conduct a general oversight review of contractor internal management functions, he is not entitled to access to internal management records for such a purpose.

5. It is not good public policy to permit DCAA or the DOD IG to have access to internal management records because to do so is not cost-effective, it results in over-regulation (assumption of the contractors' management role by the government), and it constitutes an unwarranted intrusion into the private business affairs of contractors. Permitting access to internal management records is counterproductive because it stifles creativity and causes inefficiencies in the acquisition process and thereby increases contractor costs.

Beyond there being no legal or public policy basis for permitting DCAA and the DOD IG to have access to internal management records, there are other methods which are more efficient in achieving DCAA's and the DOD IG's goal of reducing contractor costs. Reducing regulation, including audits which involve the government in the management of contractors, and increasing the natural market incentives to reduce costs, such as competition and profit incentives, are more effective means of reducing costs.

DCAA's arguments for access to internal management records may appear initially to have some plausibility. However, upon careful analysis, they are without merit. We think that, under the circumstances, it is reasonable to infer that DCAA wants access to such records for purposes which clearly are not authorized by the specific language in the statutes and standard contract clauses granting DCAA audit access authority.

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This concludes the statement of our views concerning the legal and public policy aspects of DCAA and DOD IG contract audit practices.

If we can be of any further assistance, please let us know.

Respectfully,

Charles Stewart
President

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